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REPORT FROM THE COMMISSION

France

Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union

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1. INTRODUCTION

Article 126 of the Treaty on the Functioning of the European Union (TFEU or the Treaty) lays down the excessive deficit procedure (EDP). That procedure is further set out in Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the EDP[1], which is part of the Stability and Growth Pact (SGP). Specific provisions for euro-area Member States under the EDP are laid down in Regulation (EU) No 473/2013[2].

According to Article 126(2) TFEU, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3 %, unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value; and (b) whether the ratio of government debt to GDP exceeds the reference value of 60 %, unless it is sufficiently diminishing and approaching the reference value at a satisfactory pace[3].

Article 126(3) TFEU provides that, if a Member State does not fulfil the requirements under one or both of those criteria, the Commission has to prepare a report. That report must also "*take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State*".

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[1] OJ L 209, 2.8.1997, p. 6. The report also takes into account the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", adopted by the Economic and Financial Committee on 5 July 2016, available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm .

[2] Regulation (EU) No 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (OJ L 140, 27.5.2013, p. 11).

[3] The concepts of "sufficiently diminishing" and "satisfactory pace" are defined in Article 2(1a) of Regulation (EC) 1467/97 as being fulfilled if "the differential [of the debt ratio] with respect to the reference value has decreased over the previous three years at an average rate of 1/20th per year as a benchmark". The Regulation then provides that "the requirement under the debt criterion shall also be considered to be fulfilled if the budgetary forecasts of the Commission indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which data is available". Regulation (EC) 1467/97 further provides that "the influence of the cycle on the pace of debt reduction" should be taken into account. Those elements have been translated into a debt reduction benchmark, as set out in the Code of Conduct on the SGP and endorsed by the Council. Compliance with the debt benchmark is assessed on the basis of three different configurations: the backward-looking, the forward-looking and the debt reduction benchmark adjusted for the impact of the cycle.

This report, which represents the first step in the EDP, analyses France's compliance with the deficit and debt criterion of the Treaty, with due regard to the economic background and other relevant factors.

Data notified by the French authorities on 29 March 2019[4] and subsequently validated by Eurostat[5] show that the general government deficit in France reached 2.5% of GDP in 2018, while debt stood at 98.4% of GDP, above the 60% of GDP Treaty reference value. For 2019, the notification planned a deficit of 3.1% of GDP and a debt ratio of 98.9% of GDP. France's 2019 Stability Programme (the Stability Programme) received by the Commission on 26 April 2019 confirmed those plans. The Stability Programme plans the deficit to go back below 3% of GDP in 2020. The Commission 2019 spring forecast, released on 7 May 2019, confirms those projections.

Article 2(1a) of Regulation (EC) No 1467/97 provides that Member States that were subject to an EDP on 8 November 2011 benefit from a three-year transition period, starting in the year following the correction of the excessive deficit, during which they are expected to make sufficient progress towards compliance with the debt reduction benchmark. In the case of France, the transition period covers the years 2018-2020 (i.e. three years after the correction of the excessive deficit[6]). The "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes" of 15 May 2017 spell out how the requirement for the structural balance is defined and assessed. In particular, they define a minimum linear structural adjustment of the structural balance (MLSA) ensuring that the debt reduction benchmark is met by the end of the transition period. The notified data show that France did not make sufficient progress towards compliance with the debt reduction benchmark in 2018 (see Table 1), as the gap to the required MLSA is 0.5 percentage points (pp.) of GDP. According to the Commission 2019 spring forecast, France is not expected to make sufficient progress towards compliance with the debt reduction benchmark in 2019 and 2020, as the structural effort is projected to remain at 0.0% of GDP in both years, compared to a required MLSA of 0.9% and 1.8% of GDP, respectively.

France's insufficient progress towards compliance with the debt reduction benchmark in 2018 and the planned deficit for 2019 provide evidence of a *prima facie* existence of an excessive deficit for the purposes of the Stability and Growth Pact before, however, considering all factors as set out below.

The Commission has therefore prepared this report to comprehensively assess the insufficient progress towards compliance with the debt reduction benchmark and the planned breach of the 3% of GDP Treaty reference value and examine whether the launch of an EDP is

4 According to Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of France can be found at: https://ec.europa.eu/eurostat/documents/1015035/9720700/FR-2019-04.pdf/5cbc6cea-001d-45ea-a00d-d3df1d36ff5e

5 Eurostat news release No 67/2019, https://ec.europa.eu/eurostat/documents/2995521/9731224/2-23042019-AP-EN/bb78015c-c547-4b7d-b2f7-4fffe7bcdfad

6 Council Decision 2018/924/EU of 22 June 2018 abrogating Decision 2009/414/EC on the existence of an excessive deficit in France (OJ L 164, 29.6.2018, p. 44). All EDP-related documents for France can be found at: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure/closed-excessive-deficit-procedures/france_en.

warranted after all relevant factors have been considered. Section 2 of the report examines the deficit criterion. Section 3 examines the debt criterion. Section 4 deals with public investment and other relevant factors, including the assessment of compliance with the required adjustment path towards the medium-term budgetary objective (MTO). The report takes into account the Commission 2019 spring forecast.

Table 1. General government deficit and debt (% of GDP)

		2015	2016	2017	2018	2019		2020	
						COM	SP	COM	SP
Deficit criterion	General government balance	-3,6	-3,5	-2,8	-2,5	-3,1	-3,1	-2,2	-2,0
Debt criterion	General government gross debt	95,6	98,0	98,4	98,4	99,0	98,9	98,9	98,7
	Change in structural balance	0,2	0,0	0,1	0,2	0,0	0,2	0,0	0,1
	Required MLSA	n.r.	n.r.	n.r.	0,7	0,9	0,8	1,8	1,4

Source: 2019 Stability Programme (SP) and Commission 2019 spring forecast (COM)

2. DEFICIT CRITERION

France registered a headline deficit of 2.5% of GDP in 2018. Based on the Commission 2019 spring forecast and on plans in the Stability Programme, France’s headline general government deficit in 2019 is expected to increase to 3.1% of GDP, thereby exceeding the 3% of GDP Treaty reference value. Although in excess of 3% of GDP, the general government deficit is planned to remain close to the Treaty reference value.

At the same time, the excess over the Treaty reference value is not exceptional, as it neither results from an unusual event nor from a severe economic downturn for the purposes of the Treaty and the SGP. The Commission spring forecast projects 1.3% real GDP growth in 2019, 0.3 percentage points lower than the previous year, then resuming to 1.5% in 2020 (non-calendar adjusted) while the output gap is projected to be increasingly positive.

The excess over the 3% of GDP reference value is temporary for the purposes of the Treaty and the SGP. In particular, both the Stability Programme and the Commission 2019 spring forecast project the deficit to return to below the reference value in 2020. For 2020, the Stability Programme plans a deficit at 2.0% of GDP, whereas the Commission forecast projects the deficit to amount to 2.2% of GDP. The difference between the two sets of projections stems mainly form the customary no-policy change assumption underpinning the Commission forecast. Specifically, the Commission forecast for 2020 does not take into account savings stemming form the under indexation of pensions, as that measure was cancelled by the French Constitutional Council at the end of 2018. For the outer years covered by the Stability Programme, the deficit is planned at 1.6% and 1.2% of GDP in 2021 and 2022, respectively.

In sum, the planned deficit for 2019 remains close to but above the 3% of GDP Treaty reference value. The excess is considered to be not exceptional, although temporary for the purposes of the Treaty and the SGP. Hence, the analysis suggests that *prima facie* the deficit criterion for the purpose of the Treaty and Regulation (EC) No 1467/97 is not fulfilled based on the Stability Programme and the Commission 2019 spring forecast before, however, due consideration is given to all relevant factors set out below.

3. DEBT CRITERION

In 2018, the government debt-to-GDP ratio stabilised at 98.4%. The debt-increasing effect stemming from the headline primary deficit and interest expenditure was offset mainly by real GDP growth and the increase in the GDP deflator, both through the denominator effect, and by the marginally debt-reducing impact of stock-flow adjustments.

The Commission 2019 spring forecast expects an increase to 99.0% of GDP in 2019, linked to the deterioration of the primary balance. The debt-reducing impact from the snowball effect is however projected to strengthen as a result of the increase in nominal GDP growth, whereas interest payments are expected to bottom-out. Stock-flow adjustments are expected to be just mildly positive.

According to the Commission 2019 spring forecast, the government debt ratio is expected to decline marginally in 2020, to 98.9% of GDP, due to the continued debt-reducing impact from the snowball effect. This is almost entirely compensated by the upward pressure from the primary balance, although lower than in previous years, and from the stock-flow adjustments.

The debt projections contained in the Stability Programme are broadly in line with those of the Commission. The debt ratio is projected increase to 98.9% of GDP at the end of 2019, before declining to 98.7% of GDP in 2020. The difference with respect to the Commission's projection at unchanged policies stems mainly from a lower planned headline deficit in the Stability Programme for 2020, with broadly similar nominal GDP growth assumptions.

Following the abrogation of the EDP in June 2018, France is subject to a three-year transition period during which it should ensure sufficient progress towards compliance with the debt reduction benchmark. That transition period started in 2018 and will end in 2020. In order to ensure continuous and effective progress towards compliance during the transition period, Member States should respect simultaneously the two conditions below:

a. First, the annual structural adjustment should not deviate by more than ¼% of GDP from the MLSA ensuring that the debt reduction benchmark is met by the end of the transition period;

b. Second, at any time during the transition period, the remaining annual structural adjustment should not exceed ¾% of GDP (unless the first condition implies an annual effort above ¾% of GDP);

The notified data show that France did not make sufficient progress towards meeting the debt reduction benchmark in 2018 (see Table 1), as the gap to the MLSA amounted to 0.5% of GDP. France is nor forecast to make sufficient progress in 2019 and 2020. According to the Commission, the structural balance is forecast to barely change in 2019, thereby falling short of the required improvement of 0.9% of GDP under the MLSA. For 2020, the structural balance is also projected to remain largely stable, which would imply a sizeable deviation from the required improvement of 1.8% of GDP under the MLSA. The projected deviations exceed in all years ¼% of GDP and the remaining annual structural adjustment always exceeds ¾% of GDP over the transition period. Accordingly, France would exceed the room for manoeuvre embedded in the rule.

On the basis of the scenario included in the Stability Programme, sufficient progress towards meeting the debt reduction benchmark would also not be ensured as of 2019 as the recalculated structural efforts are planned to fall short of the required improvements under the

MLSA by 0.6% of GDP in 2019 and 1.3% of GDP in 2020. The lower structural effort estimated by the Commission for 2019 is mainly due to the different treatment of two measures in terms of their one-off nature, with a total impact of about 0.1% of GDP. Specifically, the Commission 2019 spring forecast treats as one-off the increase of the fifth instalment of corporate income tax, while it does not so for the change of recording of sales of Hertzian licences.

Table 2: Debt dynamics

	2015	2016	2017	2018	2019		2020	
	COM	COM	COM	COM	COM	SP	COM	SP
Government gross debt ratio	95.6	98.0	98.4	98.4	99.0	98.9	98.9	98.7
Change in debt ratio [b] (1 = 2+3+4)	0.7	2.4	0.5	0.0	0.6	0.5	-0.1	-0.2
Contributions:								
• Primary balance (2)	1.6	1.7	1.0	0.8	1.5	1.5	0.5	0.5
• 'Snowball' effect (3)	-0.1	0.3	-0.9	-0.7	-0.9	-0.9	-1.0	-1.1
of which:								
Interest expenditure	2.0	1.8	1.7	1.7	1.6	1.5	1.6	1.5
Real GDP growth	-1.0	-1.1	-2.1	-1.5	-1.3	-1.3	-1.4	-1.4
Inflation (GDP deflator)	-1.1	-0.4	-0.5	-0.9	-1.3	-1.1	-1.2	-1.1
• Stock-flow adjustment (4)	-0.8	0.4	0.3	-0.1	0.1	-0.1	0.4	0.4

Notes:

[a] In percent of GDP.

[b] The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t}-\frac{D_{t-1}}{Y_{t-1}}=\frac{PD_t}{Y_t}+\left(\frac{D_{t-1}}{Y_{t-1}}*\frac{i_t-y_t}{1+y_t}\right)+\frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect, measuring the combined effect of interest expenditure and economic growth on the debt ratio.

Source: 2019 Stability Programme (SP) and Commission 2019 spring forecast (COM)

Likewise, the lower fiscal effort by 0.1 pp. projected for 2020 by the Commission is due to the customary no-policy change assumption in the Commission’s projections. Specifically, the Commission 2019 spring forecast does not take on board the EUR 3.4 billion savings stemming from the under indexation of pensions, as that measure was cancelled by the French Constitutional Council at the end of 2018. Although the government has announced that those savings will be attained, the measures underpinning them are not sufficiently detailed at this stage.

The analysis thus suggests that *prima facie* the debt criterion for the purpose of the Treaty and Regulation (EC) No 1467/97 is not fulfilled based on the 2018 outturn data and the Commission 2019 spring forecast as well as the Stability Programme before, however, due consideration is given to all relevant factors set out below.

4. RELEVANT FACTORS

Article 126(3) TFEU provides that the Commission report “*shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State*”. Those factors are further clarified in Article 2(3) of Regulation (EC) No 1467/97, which also provides that “*any other factors which, in the* *opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with the deficit and debt criteria and which the Member State has put forward to the Council and to the Commission*" need to be given due consideration.

When assessing compliance on the basis of the deficit criterion, if the ratio of the government debt to GDP exceeds the reference value, relevant factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit if the double condition of the overarching principle – that, before those relevant factors are taken into account, the general government deficit remains close to the reference value and its excess over the reference value is temporary – is fully met.

In case of apparent breach of the debt criterion, the analysis of the relevant factors is particularly warranted given that debt dynamics are to a larger extent influenced by factors outside the control of the government than is the case for the deficit. This is recognised in Article 2(4) of Regulation (EC) No 1467/97, which provides that the relevant factors shall be taken into account when assessing compliance on the basis of the debt criterion irrespective of the size of the breach. In that respect, at least the following three main aspects need to be considered (and have been considered in the past) when assessing compliance with the debt criterion given their impact on the debt dynamics and sustainability:

1. adherence to the MTO or the adjustment path towards it, which, is supposed to ensure sustainability or rapid progress towards sustainability under normal macroeconomic circumstances. As by construction the country-specific MTOs take into account the debt level and implicit liabilities, compliance with the MTO or the adjustment path towards it should ensure convergence of the debt ratios towards prudent levels at least in the medium term;

2. structural reforms, already implemented or detailed in a structural reform plan, which are expected to enhance sustainability in the medium term through their impact on growth, thereby contributing to bring the debt-to-GDP ratio on a satisfactory downward path. Overall, adherence to the MTO (or the adjustment path towards it) alongside with the implementation of structural reforms (in the context of the European Semester) is expected under normal economic conditions to bring debt dynamics on a sustainable path through the combined impact on the debt level itself (through the achievement of a sound budgetary position at the MTO) and on economic growth (through the reforms).

3. unfavourable macroeconomic conditions, and in particular low inflation, which can hamper the reduction of the debt-to-GDP ratio and make compliance with the SGP provisions particularly demanding. A low-inflation environment makes it more demanding for a Member State to comply with the debt reduction benchmark. Under such conditions, adherence to the MTO or the adjustment path towards it is a key relevant factor in assessing compliance with the debt criterion.

In view of those provisions, the following subsections consider in turn (1) the medium-term budgetary position, including an assessment of compliance with the required adjustment towards the MTO and the development of public investment; (2) the developments in the medium-term government debt position, its dynamics and sustainability; (3) the medium-term economic position; (4) other factors considered relevant by the Commission; and (5) other factors put forward by the Member State.

4.1. Medium-term budgetary position

Based on the ex-post assessment, France was broadly compliant with the required adjustment path towards the MTO in 2018. As regards 2019 and 2020, given that there is a risk of significant deviation from the required adjustment path towards the MTO, the fiscal adjustment is not expected to be sufficient to comply with the preventive arm requirements for France.

Headline, structural balance and adjustment towards the MTO

Headline balance

France's headline deficit fell from 2.8% of GDP in 2017 to 2.5% in 2018. The revenue-to-GDP ratio declined by 0.1 pp. of GDP, whereas the expenditure-to-GDP ratio fell by 0.4 pp. of GDP. Based on the Commission 2019 spring forecast and on plans in the Stability Programme, France's deficit in 2019 is expected to increase to 3.1% of GDP. For 2020, the Commission spring forecast projects the deficit to decline to 2.2% of GDP.

The projected increase of the headline deficit in 2019 compared to 2018 stems from the statistical impact of the transformation of the tax credit for competitiveness and employment (CICE) into a permanent outright reduction of employer's social contributions, which accounts for about 0.9% of GDP (see section 4.4). That impact is considered as a one-off, therefore having no negative impact per se on the projected fiscal stance. Without that effect, the headline deficit would be projected at 2.2% of GDP.

MTO and structural balance

In its Stability Programme, France confirmed its MTO at -0.4% of GDP. The MTO appears sufficiently stringent under what can be considered as normal economic conditions to ensure compliance with the debt rule in the medium and long term. According to the Stability Programme, France does not plan to achieve its MTO by 2022. Based on the information in the Stability Programme, the recalculated structural effort planned by France amounts to 0.2%, 0.1%, 0.2% and 0.3% of GDP in 2019, 2020, 2021 and 2022, respectively. According to the Commission 2019 spring forecast, the structural balance is expected to barely change in 2019 and 2020.

Compliance with the recommended adjustment towards the MTO

In 2017, France was recommended to ensure that the nominal growth rate of net primary government expenditure does not exceed 1.2% in 2018, corresponding to an annual structural adjustment of 0.6% of GDP. Based on outturn data and the Commission forecast, the growth of primary government expenditure, net of discretionary revenue measures and one-offs, exceeded the expenditure benchmark, leading to a deviation of 0.3% of GDP in the underlying fiscal position, thus pointing to some devation from the recommended adjustment path towards the MTO in 2018. In turn, the structural balance improved by 0.2 percentage points of GDP in 2018, thus also pointing to some deviation by 0.4% of GDP from the recommended structural adjustment of 0.6% of GDP towards the MTO. This calls for an overall assessment.

The overall assessment does not show any significant discrepancy between the two metrics. The observed revenue windfalls (by 0.1 pp. of GDP) and the higher-than-average potential growth used in its calculation (by also 0.1% of GDP) favoured the fiscal adjustement gauged with the change in the structural balance. However, the change in the structural balance was penalised by the pick-up in public investment (by 0.1% of GDP) linked to the local electoral cycle. Accordingly, the overall assessment points to some deviation from the recommended adjustment path towards the MTO in 2018.

In 2018, France was recommended to ensure that the nominal growth rate of net primary government expenditure does not exceed 1.4% in 2019, corresponding to an annual structural adjustment of 0.6% of GDP. According to the the Commission 2019 spring forecast, the growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of 1.4% in 2019, by a margin of 0.8% of GDP, thus pointing to a risk of significant deviation from the recommended adjustment path towards the MTO. The change in the structural balance is estimated at 0.0% of GDP, falling short of the required adjustment by 0.6% of GDP, also pointing to a risk of significant deviation. This calls for an overall assessment.

The overall assessment shows that the fiscal effort measured by the change in the structural balance is mainly favoured by the projected revenue windfalls by 0.2% of GDP, the forecast decline in interest payments and the estimated potential groth above its medium-term average. Those factors are offset only in part by the projected acceleration of public investment in 2019 linked to the electoral cycle. Therefore, the growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is deemed to provide a more accurate picture of the underlying fiscal effort.

Accordingly, the overall assessment points to a risk of significant deviation from the recommended adjustment path towards the MTO in 2019. Taking 2018 and 2019 together, the average deviation from the expenditure benchmark pillar amounts to 0.6% of GDP, while the average shortfall in the accumulated change in the structural balance would amount to 0.5% of GDP, thereby confirming a risk of significant deviation in 2019.

As for 2020, based on the Commission 2019 spring forecast, the growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of 1.2%, leading to a deviation of 0.7% of GDP in the underlying fiscal position, thus pointing to a risk of significant deviation from the recommended adjustment path towards the MTO. The change in the structural balance is estimated at 0.0% of GDP, falling short of the required adjustment by 0.6% of GDP and pointing also to a risk of significant deviation. The overall assessment does not show material differences between the two metrics. Taking 2019 and 2020 together, the average deviation from the expenditure benchmark pillar amounts to 0.7% of GDP, while the average shortfall in the accumulated change in the structural balance would amount to 0.6% of GDP, also pointing to a risk of significant deviation from the recommended adjustment path towards the MTO in 2020.

Public investment

According to the Commission 2019 spring forecast, public investment is projected to rise from 3.4% of GDP in 2018 to 3.5% in 2019 due to an acceleration of local government investment in the run-up to municipal elections in 2020. In 2020, however, public investment is forecast to decline to 3.4% of GDP, also linked to the deceleration of local investmet projects in the year when municipal elections are held. In 2017 and 2018 public investment was lower than the general government deficit and is projected to remain so until 2020.

The French government launched an ambitious Investment Plan (Grand Plan d'Investissement 2018-2022) in the second half of 2017. The main objective of the plan was to promote a reorientation of the structure of the French economy by ensuring an environmental transition, enhancing individual and social skills by promoting education, fostering competitiveness via innovation and promoting digitisation. The Investment Plan aimed to mobilise additional public spending on investment worth EUR 30 billion spread over five years (1.3% of GDP). However, its overall final impact will depend on the multiplier effect of public funds on private sector's resources and to its ability to effectively boost total factor productivity.

4.2. Medium-term government debt position

Debt dynamics

Public debt rose steadily between 2013 and 2017, from 93.4% to 98.4% of GDP, due to the cumulated high general government deficits recorded over the same period as well as by the low nominal GDP growth in most of the years. In 2018, the public debt-to-GDP ratio stabilised at 98.4%. The debt-increasing effect stemming from the headline primary deficit and interest expenditure was offset by real GDP growth, the increase in prices (inflation effect), both through the denominator effect, and by the marginally debt-reducing impact of stock-flow adjustments.

According to the Commission 2019 spring forecast, the public debt ratio is expected to peak at 99.0% of GDP in 2019 and start to decrease in 2020. The primary deficit is planned to temporarily increase to 1.5% in 2019 due to the above-mentioned impact of the transformation of the CICE into an outright cut in social contributions. Once that effect vanishes, the primary deficit is forecast to narrow to 0.5% of GDP in 2020.

The snowball effect contibuted to offsetting the impact of the primary deficit in 2017 and 2018, mainly due to the acceleration in nominal GDP growth (both from its real and price components). While real growth lost some momentum in 2018, inflation accelerated so that the joint debt-reducing effect only declined by 0.2 pps. In turn, interest payments declined by 0.1 pp. of GDP in 2017, to 1.7%, and remained at that level in 2018. For 2019 and 2020, despite the projected deceleration of GDP in real terms, the contribution of nominal growth to debt reduction is forecast to strengthen due to the projected increase in inflation, while the interest burden on government debt is forecast to decline by an additional 0.1 pp. of GDP.

The stock-flow adjustments are expected to be marginally positive in 2019, whereas in 2020 they are set to contribute to increasing the public debt ratio by 0.4 pps. Their debt-increasing contribution is mainly explained by the net impact of premium on debt issuance ("prime et décote à l'émission net de l'étalement des primes passées") and the residual budgetary effects in cash terms of the CICE transformation after 2019.

Debt projections in the 2019 Stability Programme are largely in line with the Commission forecast.

Interest expenditure

In line with the general trend in the euro area, interest rates on French debt instruments remain at historical lows. The ten-year bond yield averaged 0.55% during the first quarter of 2019. The spread between French and German bonds has been broadly stable since 2014, at around 40 basis points. More concretely, it averaged 38, 49, 39 and 48 basis points in 2016, 2017, 2018 and the first quarter of 2019, respectively, compared to a maximum of 154 basis points at the end of November 2011. The implicit interest rate has shown a broadly steady decline since 2008, from 4.6% to 1.8% in 2018. According to the Commission 2019 spring forecast, the implicit interest rate on government debt is projected to decline further to 1.7% in 2019 and 2020.

Debt sustainability

The French authorities have been using favourable market conditions to refinance the outstanding debt against much lower rates at longer maturity. The average maturity of total outstanding debt has increased to almost 7.9 years in 2018 compared to 7.8 years in 2017. Specifically, the average maturity is above 8 years for medium and long-term debt.

Moreover, the average maturity and the diversification of the investors' base reduce the short-term risks linked to high public debt. As French debt is denominated in euro, there is no currency risk. In addition, the French debt remains an investment sought for complying with capital and liquidity requirements as well as for diversification purposes, even if the share of non-resident holders of negotiable government debt has continued to decrease over time, to reach around 54% in 2018, which is broadly evenly distributed between euro area and other countries.

The sustainability indicators have been updated with the Commission 2019 spring forecast. Based on the S0 indicator, no significant sustainability challenges are expected in the short term in spite of the high public debt ratio. While the fiscal sub-index of S0 indicates some short-term vulnerabilities, notably driven by the cyclically-adjusted deficit and the high net government debt, the financial and competitiveness sub-index points to low risk. The low short-term risk is confirmed by the 'AA stable' rating given by the three major rating agencies to French government debt.

However, France faces a high public debt sustainability risk in the medium term. The S1 indicator is used to assess medium-term sustainability challenges. According to that indicator, an additional cumulative gradual improvement in the French structural primary balance of 5.0 pps. of GDP would be required over five years (starting from 2021) to reduce the debt ratio to 60 % of GDP by 2033. Its value is primarily related to the high level of government debt, contributing 3.0 percentage points of GDP. The unfavourable initial budgetary position (defined as the gap to the debt-stabilising primary balance) would contribute 1.6 percentage points of GDP and the remaining 0.4 pps. would be due to the projected increase in age-related public spending.

Public debt projections are especially sensitive to interest rate and growth developments. Higher interest rates or lower projected annual GDP growth would lead to higher debt ratios after 10 years by around 6 pps. of GDP.

The long-term fiscal sustainability risk indicator S2 is at 0.4 % of GDP. In the long-term, France therefore appears to face low fiscal sustainability risks, primarily related to the initial budgetary position, contributing 1.9 percentage points of GDP, which is largely offset by the projected decline in age-related expenditure, mainly in pensions. Nevertheless, given the high medium-term risks, the overall long-term fiscal sustainability risks are assessed as medium for France.

Sufficient progress towards France's MTO, as required by the Stability and Growth Pact, would put the debt on a sustained downward path, falling to 79% of GDP by 2029. However, the fiscal effort required for reaching the MTO is substantial, considering that the structural deficit is estimated at 2.5% of GDP in 2020 at unchanged policies.

4.3. Medium-term economic position

Since 2016, real GDP growth has been above potential in France. Between 2012 and 2016, a deceleration of economic activity and a protracted period of low inflation made debt reduction more difficult. Nominal growth increased starting 2017 and is expected to remain robust until 2020. Hence, it cannot be argued that macroeconomic conditions are a mitigating factor in explaining France's lack of sufficient progress towards meeting the debt reduction benchmark in 2018.

France made some progress in addressing the 2018 Country Specific Recommendations[7]. In particular, it undertook important structural reforms to reform the vocational system and made some progress in moderating developments in the minimum wage, symplifying the tax system and reducing red tape so as to support competitiveness.

Cyclical conditions, potential growth and inflation

The French economy proved to be rather resilient following the global economic recession in 2009. Economic activity decreased by 2.9% in 2009 but rebounded in 2010 and 2011. It then slowed down markedly in 2012 and gradually recovered afterwards, with GDP growth close to an annual average of 1%. GDP growth increased significantly in 2017, to 2.2%, but moderated in 2018 and is expected to further decline in 2019 and 2020, while remaining above potential.

Potential growth has declined since the 2008 financial crisis, as observed in most major euro area economies. The growth rate of potential GDP decreased from 1.8% on average from 2000 to 2008 to just 1.0% between 2009 and 2018. It is projected to gradually regain momentum and reach 1.3% in 2020. In the case of France, the slowdown in potential GDP growth mostly reflects the continuation of a long-term trend of declining gains in total factor productivity, which have been only partly compensated recently. Somewhat lower capital accumulation has also weighed on potential growth, despite the gross investment rate of the non-financial corporations being relatively resilient throughout the crisis.

According to the Commission's estimates based on the 2019 spring forecast, the output gap closed in 2017 and is expected to become positive afterwards, with GDP growth remaining above potential. The output gap is projected to reach 0.7% in 2020.

After a protracted period of low domestic price growth until 2016, inflation in France rose from 1.2% in 2017 to 2.1% in 2018. Price pressures in 2018 were mostly driven by oil prices and increases in tobacco and energy taxes. Hence, the GDP deflator remained significantly below inflation as measured by the HICP in 2018, at 0.9%, and is expected to increase to 1.3% in both 2019 and 2020, close to HICP inflation. Nominal GDP is thus expected to increase from 2.5% in 2018 to 2.7% in 2019 and 2.9% in 2020.

[7] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018H0910(09)&from=EN

Table 3: Macroeconomic and budgetary developments[a]

	2015	2016	2017	2018	2019		2020	
	COM	COM	COM	COM	COM	SP	COM	SP
Real GDP (% change)[b]	1.1	1.2	2.2	1.6	1.3	1.4	1.5	1.4
GDP deflator (% change)	1.1	0.2	0.7	0.9	1.3	1.2	1.3	1.2
Potential GDP (% change)	0.9	1.0	1.1	1.2	1.2	1.4	1.3	1.4
Output gap (% of potential GDP)	-1.2	-1.0	0.0	0.4	0.5	0.4	0.7	0.5
General government gross debt	95.6	98.0	98.4	98.4	99.0	98.9	98.9	98.7
General government balance	-3.6	-3.5	-2.8	-2.5	-3.1	-3.1	-2.2	-2.0
Primary balance	-1.6	-1.7	-1.0	-0.8	-1.5	-1.5	-0.5	-0.5
One-off and other temporary measures	0.0	-0.1	0.0	-0.2	-0.9	-1.0	-0.1	-0.1
Government gross fixed capital formation	3.4	3.4	3.3	3.4	3.5	3.5	3.4	3.4
Cyclically-adjusted balance	-2.9	-2.9	-2.8	-2.8	-3.4	-3.3	-2.6	-2.3
Cyclically-adjusted primary balance	-0.9	-1.0	-1.0	-1.1	-1.8	-0.8	-1.0	-0.7
Structural balance[c]	-2.8	-2.8	-2.7	-2.6	-2.6	-2.3	-2.5	-2.2
Structural primary balance	-0.8	-1.0	-1.0	-0.9	-0.9	-0.8	-0.9	-0.7

Notes:

[a] In percent of GDP unless specified otherwise.

[b] Calendar-adjusted only in the SP.

[c] Cyclically-adjusted balance excluding one-off and other temporary measures.

Source: 2019 Stability Programme (SP) and Commission 2019 spring forecast (COM)

Structural reforms

Since 2017, France has engaged in a comprehensive set of reforms that aim to contain public expenditure, lower the tax burden on companies and make the labour market more flexible. Reforms have gained momentum but their full implementation remains crucial and further reforms are warranted. The effects of the labour market reform adopted in 2017 have started to materialise and improvements in the business environment should be amplified with the new PACTE law, adopted in 2019. The investment plan (Grand plan d'investissement 2018–2022) could also help boost growth and employment. The plan's priorities are considered appropriate to address deficiencies characterising the French economy. Significant challenges persist, in particular, concrete actions remain warranted to implement the planned expenditure savings to put public debt on a steady downard trajectory.

In its 2019 Country Report[8], the Commission assessed that France has made some progress in addressing the 2018 Country Specific Recommendations and that the reform agenda has continued despite a slowdown in economic activity. More specifically, France has made substantial progress in pursuing the reform of vocational education and training. Some progress was made in moderating developments in the minimum wage, simplifying the tax system and reducing red tape. Only limited progress has been made in reforming the pension system, improving access and equal opportunities in the job market, increasing competition in services and increasing efficiency of the innovation system. There has been no progress in further developing and implementing a spending review through the Public Action 2022 programme. Measures to decrease public expenditure and increase its efficiency are still not sufficiently defined.

[8] See Commission Staff Working Document SWD (2019) 1009 final, 27.2.2019, "*Country Report France 2019. Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*".

In 2018, France's macroeconomic imbalances (mainly related to high public debt and weak competitiveness dynamics) stopped deteriorating but remained elevated. As a result, the Commission concluded that France still displays macroeconomic imbalances[9].

The government is envisaging to propose measures in 2019 to simplify the functioning of the pension system and to reform the unemployment benefit system. On pensions, a law is planned to be adopted to progressively unify the rules of the different pension schemes that currently co-exist with a view to improving the transparency, equity and efficiency of the system. A more efficient pension system could help mitigate public finance sustainability risks in the medium term. In addition, the planned reform of the unemployment benefit system may contribute to reduce labour market segmentation and promote transitions towards open-ended contracts. The latest agreement among social partners allowed limiting the debt of the unemployment benefit system to EUR 37.1 billion at the end of 2018. New negotiations between social partners on the unemployment benefits system took place at the beginning of 2019. The aims were i) to reduce the debt of the system and ii) to amend the rules in order to reduce job insecurity and make them more conducive for the unemployed, iii) to find an incentive mechanism to decrease the separation rate of the firms when it is excessively high. Social partners have failed to find an agreement on a new set of rules though. The reform now stands in the hands of the government, which is committed to find an agreement before the end of 2019.

4.4. Other factors considered relevant by the Commission

Another factor considered relevant by the Commission is the statistical and one-off nature of the deficit and debt increases associated with the transformation of the tax credit for competitiveness and employment (CICE) into a permanent reduction of employer's social contributions.

The CICE is a scheme created in 2013. It aims at reducing social contributions of employers through a payable tax credit on corporate taxes, based on gross wages paid to employees during a given year. In national accounts, that tax credit is treated as a subsidy and it is recorded with a delay from one up to three years compared to the relevant year of the claim.

The specific recording approach and the replacement of the CICE by an equivalent reduction in social contributions produce two effects. On the one hand the reduction of contributions is registered as soon as it is implemented (i.e. 1 January 2019). On the other hand, the claims under the CICE corresponding to employees in staff in 2018 generate a subsidy which is also to be registered in 2019 although the CICE is no longer in place. The combination of these two effects generates a one-off double-cost in the year of the transformation of around 0.9% of GDP. Without that one-off effect the headline deficit in 2019 would be projected at 2.2% of GDP.

Overall, the change from CICE to a reduction in social contributions entails a transitory budgetary effect that does not lead to a sustained change in the budgetary position. As such, it is regarded as a one-off for the purposes of the Stability and Growth Pact and its impact is removed from the calculation of the fiscal effort under the preventive arm of the Pact.

[9] See Commission Communication COM (2019) 150 final, 27.02.2019 " *2019 European Semester: Assessment of progress on structural reforms, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011"*.

The replacement of the CICE by a reduction in social contributions in a budgetary neutral manner responds to the Country Specific Recommendation 2 (sub-part 1) addressed to France in 2017. Specifically, that recommendation read "Consolidate the measures reducing the cost of labour to maximise their efficiency in a budget-neutral manner and in order to scale up their effects on employment and investment", for which progress has been considered as substantial in 2019.

4.5. Other factors put forward by the Member State

On 31 May 2019, the French authorities transmitted a letter with relevant factors in accordance with Article 2(3) of Regulation (EC) No 1467/97. The analysis presented in the previous sections already broadly covers the key factors put forward by the authorities.

Specifically, regarding the deficit criterion, the French authorities argue that the planned breach of the 3% of GDP reference value in 2019 is temporary, limited and exceptional in that it stems from the exceptional cost linked to the transformation of the CICE into a permanent outright cut in social contributions, without which the deficit would be at 2.3% of GDP. The headline deficit in 2020 is planned to go down to 2% of GDP.

On the other hand, the authorities argue that public expenditure has been strongly contained, given that it declined in real terms in 2018 (by 0.3%). Moreover, the authorities claim that that such an expenditure retrenchment will continue in the future. Specifically, in 2019, the growth of public expenditure in real terms is planned to be much lower than the average over the last ten years, thanks to the under indexation of social benefits, the upcoming savings on unemployment benefits and the effective implementation of contracts with local governments.

At the same time, according to the French authorities, the public finance trajectory sketched in the Stability Programme 2019 confirms the commitment to reduce taxes further in order to support employment and households' purchasing power. In this respect, the measures adopted in response to the yellow vests crisis aim at ensuring the acceptability of the reforms undertaken and mainly frontload already planned actions.

Consequently, the authorities recall that the trajectory towards the MTO has been adapted to the new conditions, including the possibly of a lower-than-expected GDP growth over the coming years.

Regarding the debt criterion, the French authorities argue that, after taking into account the margin of tolerance allowed by the Treaty, the observed structural adjustment of 0.2% of GDP in 2018 implies compliance with the effort required under the preventive arm of the SGP.

Accordingly, the authorities claim that the foreseen convergence towards the MTO tabled in the Stability Programme 2019 ensures the sustainability of public debt.

5. CONCLUSIONS

The general government gross debt stood at 98.4% of GDP at the end of 2018, well above the 60% of GDP Treaty reference value. France did not make sufficient progress towards meeting the debt reduction benchmark in 2018. This suggests that before consideration is given to all relevant factors, the debt criterion as defined in the Treaty does not appear to have been fulfilled prima facie in 2018.

Moreover, the headline general government deficit in 2019 is planned to increase to 3.1% of GDP, thereby remaining close to but exceeding the 3% of GDP Treaty reference value. The excess is considered to be not exceptional, although temporary for the purposes of the Treaty and the SGP. Hence, the analysis suggestst that, before considering all relevant factors, the deficit criterion for the purpose of the Treaty is not fulfilled.

In line with the Treaty, this report examined the relevant factors to assess compliance with the deficit and debt criteria.

Regarding the debt criterion, based on an overall assessment of compliance with the preventive arm, France broadly complied with the recommended adjustment path towards the MTO in 2018. Moreover, short-term sustainability risks are low.

Regarding the planned breach of the 3% of GDP reference value in the Treaty, the Commission considers that the planned deviation in 2019 is marginal and temporary. Moreover, the deficit increase to 3.1% is solely due to the one-off statistical impact of the transformation of the tax credit for competitiveness and employment (CICE) into a permanent outright reduction of employer's social contributions, which amounts to 0.9% of GDP.

Overall, France has made some progress in implementing the structural reforms announced since 2017 that aim to address the Country Specific Recommendations, notably in the area of competitiveness, employment, education, vocational training and taxation. They are expected to contribute to enhancing the economy's growth potential and reducing the risks of macroeconomic imbalances, thereby having a positive impact on debt sustainability in the medium to long term.

The analysis presented in this report includes the assessment of all the relevant factors and notably: (i) the fact that France is found to be broadly compliant with the recommended adjustment path towards the MTO in 2018; (ii) short-term sustainability risks are low; (iii) the breach of the 3% of GDP reference value in 2019 is marginal, temporary and solely due to a one-off effect, and (iv) the implementation of growth-enhancing structural reforms in recent years in response to the Country Specific Recommendations addressed to France, several of which are considered to help improve debt sustainability. The analysis suggests that the deficit and debt criteria as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with. At the same time, as France is assessed to be at risk of significant deviation in 2019 and 2020, additional fiscal measures are to be taken as of 2019 to ensure compliance with the adjustment path towards the MTO.