G R O U P   O F   T W E N T Y

FRANCE
SUSTAINABILITY REPORT [1]

Prepared by Staff of the

I N T E R N A T I O N A L   M O N E T A R Y   F U N D

[1] *Report 5 of 10.* At the request of the G-20, IMF staff has provided analyses and assessments of member's economies and policies in a *set* of reports for the Mutual Assessment Process (MAP). These reports serve as inputs for the Action Plan agreed by G-20 Leaders at the Cannes Summit. The 2011 Staff Reports for the 20 MAP consist of the following: (i) an Umbrella Report that provides an integrated summary of the component reports and an upside scenario for G-20 collective action; (ii) an Accountability Report that summarizes members' progress toward policy commitments since the Seoul Summit in 2010; (iii) a MAP Report providing analysis of members' medium-term macroeconomic and policy frameworks; and (iv) Sustainability Reports for seven members (China, France, Germany, India, Japan, United Kingdom, and United States)—indentified by G-20 indicative guidelines—to assess the root causes and policy implications of key imbalances.

EXECUTIVE SUMMARY

France's public finances have deteriorated over the past decade—owing, in part, to rising social spending pressures. At the same time, the current account balance has gradually worsened from a surplus to a moderate deficit—largely due to rising labor costs. Consolidation is needed to ensure fiscal sustainability, while structural reforms are critical to improving competitiveness and keeping the current account deficit in check.

Large fiscal imbalances reflect structural factors and the impact of the financial crisis. Public debt has increased due to rising expenditures on social security and by local governments, weaknesses in fiscal institutions, and the costs associated with the global recession.

The deterioration of the current account reflects worsening competitiveness. Wages have grown faster than in neighboring countries, while total factor productivity growth has grown relatively slowly.

France's internal imbalances need to be addressed, notably in light of the recent market concerns pertaining to its fiscal position and public debt. Sustaining confidence in sovereign creditworthiness is critical for France and the rest of the euro area.

External imbalances should be viewed with care. While the current account deficit remains modest, France should not maintain deficits for extended periods¸ given that demographic changes will likely put pressure going forward.

To address imbalances and achieve strong, sustainable, and balanced growth, France will require additional fiscal consolidation efforts over the medium term and growth-enhancing structural reforms.

- Fiscal options include: limiting local government expenditure growth, improving targeting of social transfers, reducing VAT exemptions and incentives, and moving towards a more growth-friendly tax system. It would also be critically important to improve bank capitalization to reduce risk and guard against the cost of bailouts.

- Structural reforms should be implemented to boost competitiveness and keep external imbalances in check. Reforms that improve competitiveness will bolster exports and help counterbalance the dampening effects on growth from fiscal consolidation. A comprehensive strategy should include policies to promote innovation and create favorable conditions for businesses, notably by easing regulatory restrictions. In addition, labor market reforms, such as reducing the labor tax wedge, will help increase labor force participation and productive potential.

INTERNATIONAL MONETARY FUND

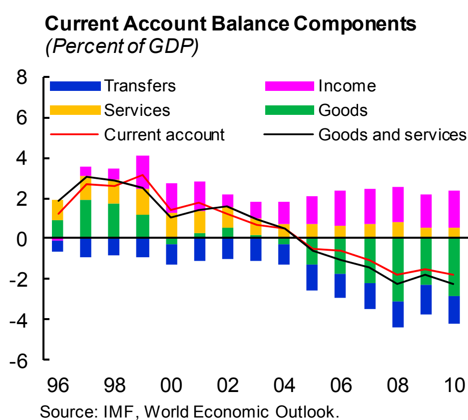
FRANCE

SUSTAINABILITY REPORT 2011[1]

France's external balances have gradually deteriorated from a surplus in late 1990s to moderate deficit in the second half of 2000s, reflecting worsening competitiveness on the back of declining trend growth. Public debt, which was on a growing path prior to the crisis, owing to rising expenditures by local governments and social security administrations, deteriorated significantly thereafter due to crisis-related costs. Going forward, France needs to improve its competitiveness to keep current account deficits in check and reduce its public debt to ensure fiscal sustainability. A comprehensive strategy to boost growth and productive potential should be implemented, including through a strengthening of incentives for work and increasing competition in product and services markets.

I. BACKGROUND

1. **France's current account balance has deteriorated gradually since the late 1990s.** Over the past decade, the current account deteriorated gradually from a surplus of 3.1 percent of GDP in 1999 to a deficit of 1.7 percent of GDP in 2010. This was led by a worsening of the trade balance on goods and services, which moved from a surplus of 2.5 percent of GDP in 1999 to a deficit of 2.3 percent in 2010, while income and transfers balances have been relatively stable.

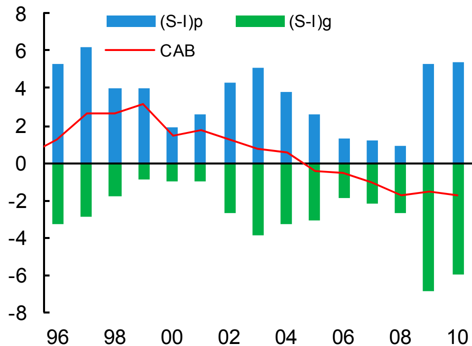


- The deterioration of the current account during the first half of the 2000s was cyclical, as *stronger domestic demand* in France relative to its key trading partners, notably Germany, resulted in worsening net exports. However, since the mid-2000s the deterioration was largely due to a worsening *exports* performance, with France's export growth lagging behind the export growth of its key competitors.

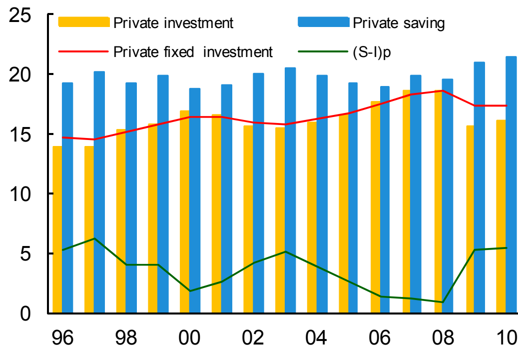
- From a *saving-investment* perspective, the current account deterioration between 1999 and 2007 (by 4.2 percentage points of GDP) was driven largely by a narrowing

[1] Prepared by Joong Shik Kang under the guidance of Emil Stavrev, with input from Stephen Snudden and the support of Eric Bang, David Reichsfeld, and Anne Lalramnghakhleli Moses.

of the private saving-investment balance on account of higher investment in construction and services (2.8 percentage points of GDP). Since 2007, notwithstanding a significant improvement in the private saving-investment balance, the current account deficit widened further as a result of a sizable deterioration of the public sector saving-investment balance (by 3.8 percentage points of GDP).



Sources: IMF, World Economic Outlook and staff estimates.



Sources: IMF, World Economic Outlook and staff estimates.

2. **The current account is projected to improve only gradually over the medium term.** Following a further deterioration in 2011, the current account deficit is projected to narrow, but only slowly on account of sluggish demand from the rest of Europe and continuing competitiveness issues.

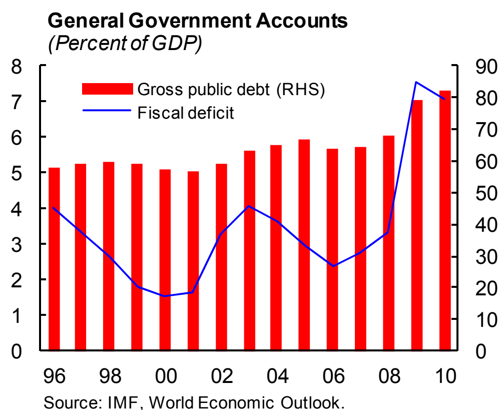
3. **Fiscal balances improved sizably in the run-up to the Economic and Monetary Union (EMU), were generally weak during EMU, and deteriorated significantly following the recent crisis.**[2]

- *To meet the Maastricht criteria, France introduced a medium-term consolidation plan in 1994.* The general government deficit was reduced significantly to 1.5 percent of GDP in 2000 (from over 6 percent of GDP in 1993), while public debt declined to about 57 percent as a share of GDP in 2001 after peaking near 60 percent in 1998.
- *In the early 2000s, rising expenditures by local governments and social security administrations pushed up the general government fiscal deficit.* Overruns in social security spending continued in the early 2000s, partly undoing the gains from the previous consolidation and the deficit exceeded 4 percent of GDP in 2003. Under the EU's rules, France entered the Excessive Deficit Procedures (EDP) of the Stability and Growth Pact (SGP). The significant consolidation package in response to the EDP, helped by the global economic boom, reduced the deficit to below 3 percent of GDP by 2005.

[2] Fiscal balances include the central government, the local governments, and the social security administration.

- *Public finances deteriorated significantly in the context of the global crisis.* Crisis-related costs, on the back of declining trend growth, resulted in sizable general government deficits (over 7 percent of GDP in 2009-10), while public debt exceeded 80 percent of GDP in 2010 and is projected to increase further in the near term. Thus, France entered the EDP again in 2009.

4. **Going forward, fiscal balances are projected to improve.** In their Stability Program, the authorities have started a large fiscal adjustment that is projected to bring down the deficit significantly by 2014 (to 2 percent of GDP) and put the public debt on a declining path. The implementation of pension reform enacted in late-2010, which includes a gradual increase of the legal retirement age from 60 to 62 years and the full pension age from 65 to 67 years, together with the recent extension of the contributory period to 41.5 years for people born after 1955 (to be adjusted in line with gains in life expectancy), will also help lower the deficits over the long term. These changes will help achieve financial equilibrium in the pension system by 2018 from a current deficit of almost 1.5 percent of GDP.



II. ROOT CAUSES OF FRANCE'S IMBALANCES

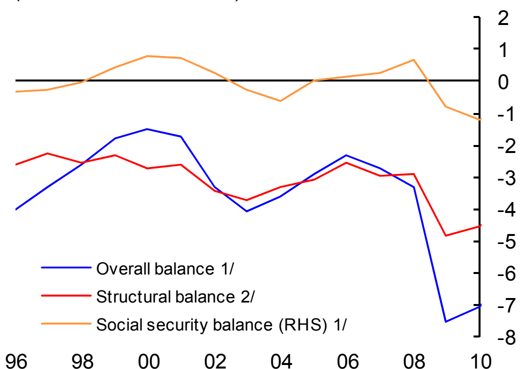
5. **G-20 indicative guidelines identified France as experiencing "moderate" or "large" external deficits and public debt, calling for a deeper assessment of the causes.**[3] Reflecting structural factors and weakness of fiscal institutions, public finances were weak prior to the crisis, despite relatively strong growth, and have deteriorated significantly thereafter owing to crisis-related costs. The external current account has gradually deteriorated (from a surplus in the early-2000s to a deficit by the end of the decade) driven by strong domestic demand and a loss in competitiveness.

A. Fiscal Imbalances

6. **The deterioration of French public finances over the past decade reflects structural factors and the costs associated with the global recession.** In the context of some weakness in fiscal institutions, the fiscal position worsened in the run-up to the crisis, largely due to rising social security spending, while crisis-related costs have added to the fiscal burden thereafter. Specifically,

[3] Gross private debt in France, which was also identified as "moderate" or "large" by the indicative guidelines, has gradually increased by about 40 percentage points of GDP over the last decade, partly driven by household mortgage financing. However, it does not present imminent risks to the economy or the financial system since the financial wealth of private sector has also risen strongly during this period.

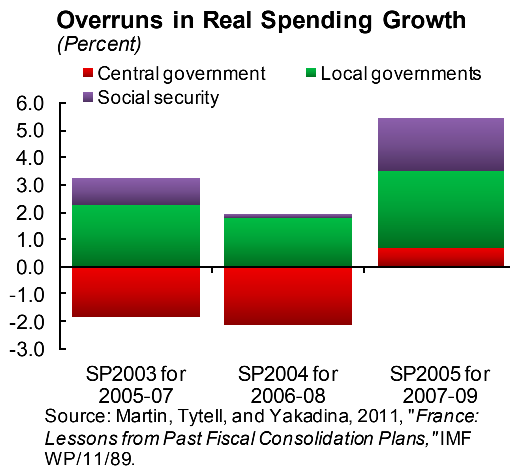
- *Structural factors, including aging-related social security spending, have contributed to the gradual deterioration of the fiscal balance*. While cyclical factors and corresponding consolidation efforts have accounted for large fluctuations in the fiscal balance, the structural balance has remained weak, mainly due to rising social security spending, including on pension and health care. Despite several efforts to increase the efficiency of the pension and health care systems, expenditure overruns on social security spending continued, contributing to the weakening of the fiscal position.



Source: IMF staff estimates.
1/ Maastricht definition. Estimate for 2010 includes one-off transfer to ODAC for future-oriented investments, which amounts to about 0.6 percent of GDP.
2/ In percent of potential GDP.

- *Weaknesses in fiscal institutions have hampered efforts to restore fiscal sustainability*. Strong growth in the mid-2000s did not lead to a much needed fiscal consolidation. The significant decentralization efforts in the early 2000s resulted in a rapid

growth of local government spending (on average 5 percent annually during 2001–10). While the favorable global economic boom contributed to the end of the first EDP in the mid-2000s, the deficit targets set in the successive Stability Programs (SPs) were frequently missed, mainly due to spending overruns by the local governments and social security system, which account for about 21½ percent and 46¼ percent of total expenditures (as of 2009), respectively, but also by the central government in the second half of the 2000s.



Source: Martin, Tytell, and Yakadina, 2011, "*France: Lessons from Past Fiscal Consolidation Plans,*" IMF WP/11/89.

- *Public finances deteriorated significantly in the context of the recent crisis, with both the deficit and the debt rising sharply*. In addition to the full operation of automatic stabilizers, the government provided discretionary fiscal stimulus in the amount of 2¼ percent of GDP over 2009–10 to cushion the downturn.[4] Combined with declining trend growth, these measures have pushed the general government deficit to above 7 percent of GDP and public debt increased to over 80 percent of GDP—one of the highest among all European AAA-rated countries.

B. External Imbalances

7. **The current account has deteriorated largely due to a worsening competitiveness of French exports as well as strong domestic demand.[5]**

- The deterioration of the trade balance in the early-2000s was mainly due to cyclically lower foreign demand. While France faced consistently lower foreign demand than its large euro area neighbors, strong domestic demand growth in France, exceeding that of its largest trading partner Germany, on average by 3 percent per year over 2001–05, resulted in strong French imports and worsening net exports, which turned negative in 2005.

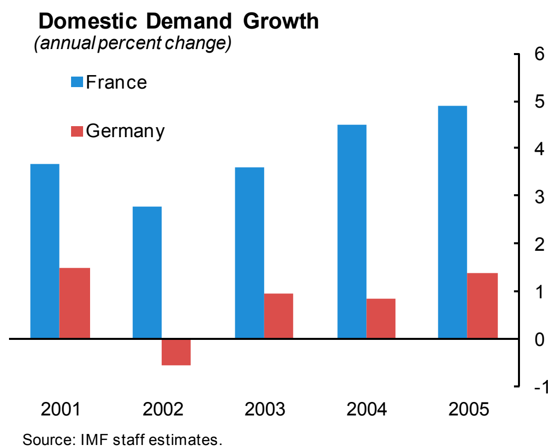
- Since 2005, export growth in France has fallen significantly below the euro area average, pulling down French export market shares both worldwide

[4] Only part of this fiscal stimulus had an impact on the general government deficit as some measures, e.g., public enterprise investments are not included in the general government accounts.

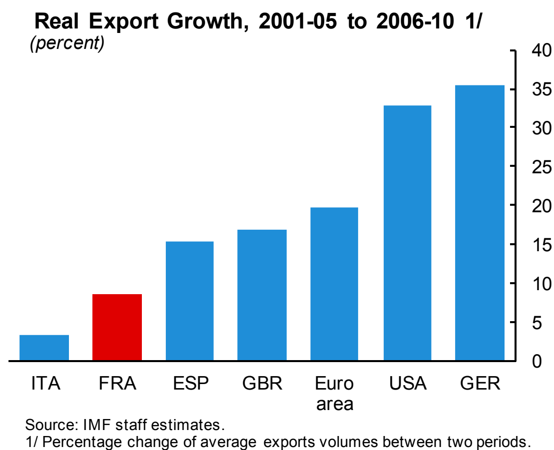
[5] Higher energy costs also contributed to the worsening current account during 2005–08.

and within the euro area. Combined with strong domestic demand, trade and current account balances continued to deteriorate, raising concerns about competitiveness of French exports.

- The current account has deteriorated further during the Great Recession as public sector demand, supported by the stimulus, more than offset the decline of private sector demand.



Source: IMF staff estimates.



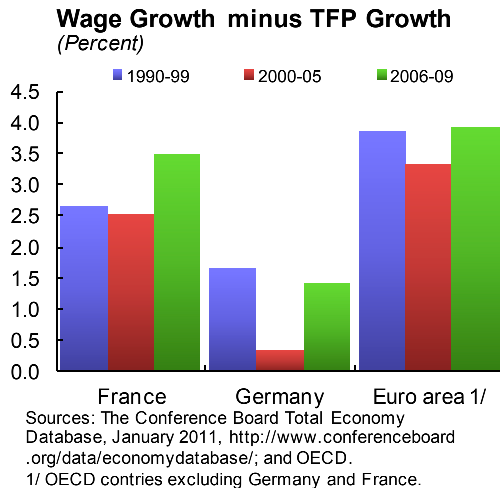
Source: IMF staff estimates.
1/ Percentage change of average exports volumes between two periods.

8. **The deteriorating competitiveness of French exports, and associated loss of market share, reflects both price and non-price factors.** France has lost about 2½ percentage points of world export market share in the last decade.[6] While most advanced economies have lost market share, owing to the increasing role of emerging economies in global trade, France's loss has been more severe than its peers. Moreover, its loss of market share in the euro area is noteworthy, given that the area accounts for about half of France's total exports—during the latter half of the 2000s, France lost about 1½ percentage points of market share in the euro area, compared to a ¼ percentage point loss for Germany.

- *A key factor behind this weakening of competitiveness was a larger gap between wage growth and total factor productivity (TFP) growth relative to neighboring countries since the mid-2000s.* In particular, relative to Germany, wages grew much faster, while TFP growth lagged for more than a decade. Traditional price-based indicators are insufficient to explain France's weaker export performance. Since the mid-2000s, all countries in the euro area experienced a real appreciation relative to the U.S. in terms of the CPI-based real effective exchange rate (REER), mainly due to the appreciation of the euro. However, relative to the other core countries in

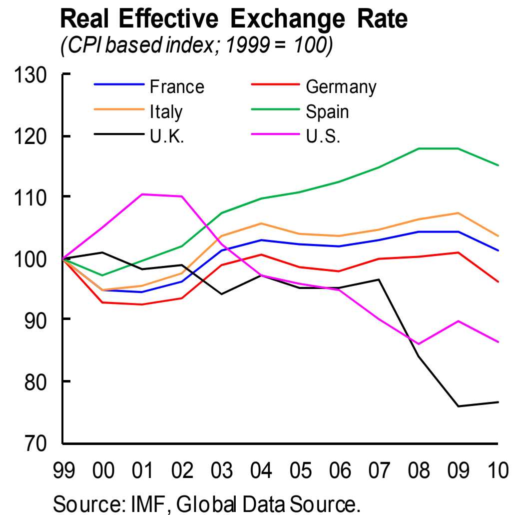
[6] Export market share is calculated by dividing France's exports by world imports. European Commission (2010, "Surveillance of Intra-Euro-Area Competitiveness and Imbalances") also pointed that France's share of exports of goods in world trade (including intra EU exports) declined by 2.2 percentage points between 1998 and 2008.

the euro area (Germany, Italy, and Spain), France lost competitiveness only to Germany in terms of REER, export prices, unit labor costs, and labor productivity. In contrast, France experienced a smaller real appreciation, slower increase in export prices and unit labor costs, and faster increase in labor productivity than Italy and Spain. This implies that non-price factors, which are related to structural issues, are likely to have contributed to the underperformance of the French export sector.[7]

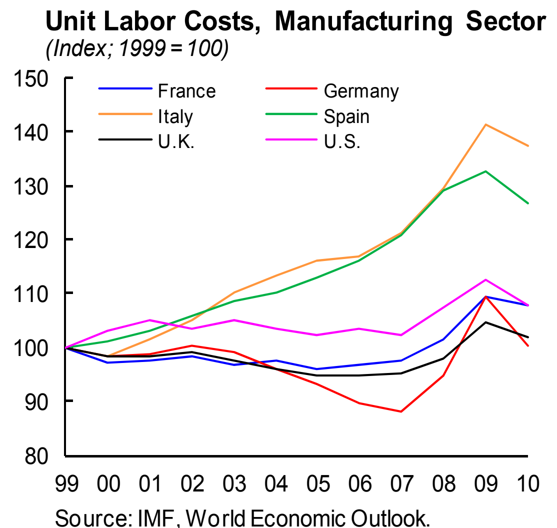


Sources: The Conference Board Total Economy Database, January 2011, http://www.conferenceboard.org/data/economydatabase/; and OECD.
1/ OECD contries excluding Germany and France.

- *French exports have faced stronger competition from emerging economies than its large euro area peers.* French exports consist of some high-tech products (aeronautics and pharmacy),



Source: IMF, Global Data Source.



Source: IMF, World Economic Outlook.

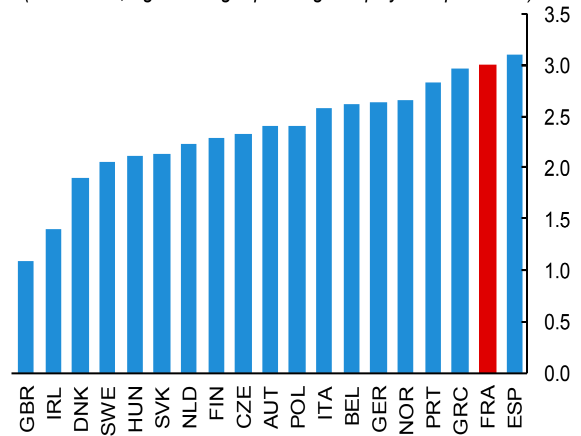
but also contain a large share of low- to medium-tech products that face competition from both industrialized and emerging economies.[8] Although France's exports to fast-growing emerging and developing countries have increased significantly during the last decade, its export growth to these

[7] Cheng (2010, "Developments in France's external competitiveness—an update") also found that traditional price and foreign demand factors can only partly explain the decline of French exports market share during the 2000s, suggesting that non-price factors may have played a significant role in the competitiveness loss.

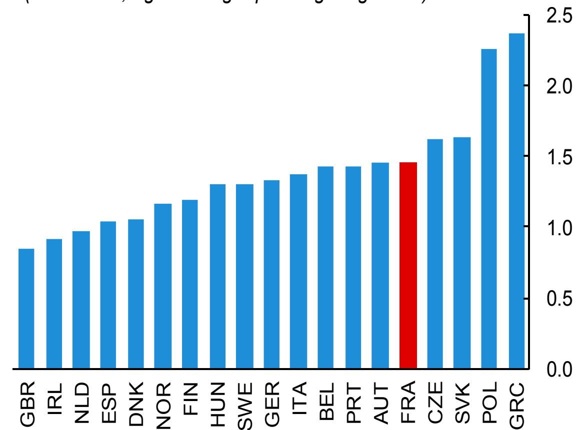
[8] See more details in European Commission (2010, "Surveillance of Intra-Euro-Area Competitiveness and Imbalances").

destinations lagged behind that of the other euro area countries. France has also lost market share in fast-growing sectors, including some of its large export sectors, in marked contrast to Germany.

- *The underperformance of the French export sector also reflects labor and product market rigidities*. Labor market rigidities have restricted firms' flexibility to adjust to the changing economic environment. A high level of employment protection, a high minimum wage, and one of the highest labor tax wedges in the OECD[9], among others, have led to high unemployment and lower working hours, contributing to low labor input. OECD estimates show that France's product market policies have also inhibited competition relative to its EMU peers.[10] These rigidities have led to loss of efficiency, inability to make a breakthrough in new markets, insufficient research and innovation, and loss of technological edge, contributing to the underperformance of France's export sector.



Source: OECD.



Source: OECD.

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[9] Earlier reforms aimed at reducing employer-paid social security contributions for low wage levels (between 1 and 1.6 times the minimum wage) have significantly lowered the tax wedge at the bottom of the income distribution.

[10] Kabundi and Nadal De-Simone (2009, "Recent French export performance: Is there a competitiveness problem?") find that adjustment to a negative cost shock tends to be more via quantities than via prices, pointing to an insufficient flexibility of labor and product markets.

III. ARE FRANCE'S IMBALANCES A PROBLEM?

A. National Perspective

9. **While a moderate current account deficit does not pose risks, it is not desirable at this stage for France.** At less than 2 percent of GDP in 2010, France's current account deficit is not excessively large. However, given demographic factors, it is not desirable for France to maintain current account deficits for extended periods. In addition, given the need for fiscal consolidation, maintaining strong growth would require a larger contribution from external demand through restoring competitiveness. Also, since lower potential growth and loss of competitiveness share common underlying factors, addressing potential growth would lead to higher welfare for French population, while also help to reduce the external imbalance.

10. **Market concerns pertaining to France's fiscal position and public debt have risen.** The recent widening of bond spreads relative to German bunds and rising CDS spreads suggest that markets are concerned about the sustainability of debt and underscore the need to stick to the announced consolidation path. High public debt reduces policy space to deal with future shocks and can crowd out private investment, lowering growth prospects. Also, as higher public debt inevitably implies a higher tax burden in the future, given the already high level of France's tax rates, it could create other distortions, undermining the on-going efforts to revitalize the economy.

B. Multilateral Perspective

11. **France's external and internal imbalances should be viewed with care, notably in light of the recent market concerns pertaining to its fiscal position.** France is the second biggest economy in the euro area. A credit event in the French debt market or a loss of investor confidence in the creditworthiness of the sovereign could therefore have significant repercussions for other sovereigns (including for the European Financial Stability Facility (EFSF), which is critical for managing the on-going euro area crisis) as well as corporate spreads. Also, given the close inter-linkages between the real and financial sectors, the risks of contagion are high, as evident from the sovereign debt crisis in peripheral euro area countries.

12. **Financial instability in France could have large cross-border spillovers.** French banks have large cross-border exposures to the euro area countries under IMF programs or experiencing higher market scrutiny.

IV. HOW TO ADDRESS IMBALANCES?

13. **The announced fiscal consolidation path is needed to keep public finances on a sustainable path, while long-standing structural reforms should be implemented to boost competitiveness and growth.** The external and fiscal imbalances are closely interlinked. A more competitive and growth-oriented economy is essential not only for keeping external balances in check, but also for putting public finances on a sustainable path. Fiscal policy that puts public finances on a sustainable path, combined with growth-friendly tax reform, could usefully support growth- and competitiveness-enhancing structural reform policies and help contain external imbalances by ensuring an improved public saving-investment balance.[11]

A. Anchoring Fiscal Sustainability

14. **A key policy priority is keeping public debt on a sustainable track.** To achieve this goal, the Stability Programs under the second EDP strike a balance between growth and sustainability concerns—they aim to reduce the fiscal deficit to 3 percent of GDP by 2013 and 2 percent by 2014. According to IMF staff assessment, the additional fiscal measures announced by the French authorities in August 2011 would help meet the deficit targets for 2011 and 2012[12] but additional measures would be required from 2013 onwards to meet the fiscal targets and to maintain public debt on a sustainable path—failing to implement such additional measures would result in higher public debt ratios (about 91 percent of GDP projected by staff versus around 85 by the authorities in 2014). Previous consolidation experience highlights that a strong political will and a shared resolve for consolidation at all levels of government, including local governments and the social security system, are critical factors for the success of fiscal consolidation.

15. **Additional consolidation efforts are needed to achieve the fiscal targets for 2013 and 2014.** Options for additional adjustment include: (i) limiting local government expenditure growth, including rationalization of responsibilities of departments, regions, and municipalities; (ii) improving targeting of social transfers through enforcing a tighter budget constraint on social security entities by replacing earmarked "social taxes" with subsidies; (iii) reducing the VAT policy gap through a gradual elimination of VAT exemptions and incentives; and (iv) a more growth-friendly

[11] Policy recommendations are based on the latest 2011 Article IV discussion.

[12] According to the government the measures would increase revenues by 1 bn euros in 2011 and by 11 bn euros in 2012 and reduce spending by 0.5 bn euros in 2011 and by 1 bn euros in 2012.

tax system, which shifts more of the burden of taxation from direct to indirect taxes.

16. **Adopting a fiscal rule based on independent macroeconomic forecasts would entrench fiscal credibility.** Adopting the draft law (already voted by the Parliament and Senate) that envisages enshrining a fiscal rule would provide for a binding medium-term budget framework and a post-consolidation anchor for fiscal policies. Since the need for realistic macroeconomic assumptions is more acute at a time when economic growth is fragile, establishing an independent public institution or fiscal council to provide forecasts that would be mandatory for budget preparation and medium-term planning would enhance the credibility of the multi-year budget.

17. **Furthermore, to ensure long-term sustainability, deeper reforms of key pension and health care parameters are also needed.** On the pension side, increasing further the legal retirement age in line with life expectancy would prevent continued increases in time spent in retirement as medical advances continue to lengthen life spans.[13] On the health care front, as the rise in living standards and technical progress will continue to put pressure on public expenditures, in addition to initiation of a planned reform of long-term care in 2012, continued efficiency gains are necessary to prevent an unsustainable rise in health and long-term care spending. It should be noted however, that France is among the lower- to medium-risk countries in terms of future healthcare costs, with the projected increase of annual spending on public health being lower than European average over the next 20 years.[14]

18. **Ensuring adequate capitalization of French banks can help limit potentially large adverse cross-border spillovers and guard against costly bailouts.** Capital adequacy has improved since the crisis but some French banks are increasing their capital at a slower pace compared with other large European banks, some of which have already met and even exceeded Basel III capital requirements (French banks announced they will fulfill Basel III criteria by 2013). If the use of a 10 percent core Tier 1 threshold became standard for market participants, some French banks would have capital deficit with respect to this threshold. Supervisors should continue to ensure that the banks implement their announced capital augmentation programs, including through limiting dividend distributions and share repurchases, if needed.

B. Enhancing Competitiveness

19. **To keep external imbalances in check, France needs to improve its**

[13] The 2003 pension reform linked the contribution years for a full pension to life expectancy.

[14] See the April 2011 Fiscal Monitor for details.

competitiveness by pursuing structural reforms to increase total factor productivity while moderating wage growth. France's lagging export performance over the last decade indicates the importance of strengthening competitiveness. The latest overall exchange rate assessment suggests the possibility of some real effective exchange rate overvaluation, indicating the need for wage moderation and cost containment is especially important given that France is a member of a currency union. To address non-price factors which have played significant roles in the underperformance of France's export sector, it is important to pursue comprehensive structural reform strategies in the product market, labor market, and tax area.

20. **The reform strategy in product markets should be focused on promoting innovation and creating favorable conditions for business.** Enhancing further competition by lowering regulatory restrictions would help increase productivity and employment. In this context, the easing of regulatory entry barriers to service industry[15], including professional services, would raise value-added in the service sector but also have positive spillovers to the manufacturing sector by reducing costs of key inputs.

21. **Labor market reform should focus on increasing labor market participation as well as re-absorbing the unemployed.** Although welcome progress has been made to re-absorb the unemployed by providing appropriate incentives for both firms and job-seekers, including by simplifying the layoff procedures and enhancing the work-study schemes, more efforts are needed. While easing high employment protection would provide appropriate incentives for firms to create more jobs, reducing the comparatively long duration of unemployment benefits or lowering benefit levels over time could strengthen incentives for job search and increase the effective labor supply.

22. **Labor market participation of young and low-skilled workers as well as seniors needs to be increased.** The high minimum wage (SMIC) has priced out of the labor market low-skilled workers, especially the young. To increase labor demand for these groups, it is important to continue to limit the increase of the SMIC, for example by reviewing the indexation formula, which is currently partly based on inflation. To increase further the labor force participation of seniors (among the lowest in Europe), it is important to continue the phasing out of pre-retirement benefits, relaxation of constraints on combining employment and retirement benefits, and pension reforms.

[15] A new reform that is envisaged to reinforce competition in the services sector is expected to be adopted by the end of 2011.

Employment Ratios

	Total 1/	Women 2/	Older workers 3/
	2010	2010	2010
Belgium	62.5	56.5	37.3
Finland	69.3	66.9	56.3
France	64.4	59.9	39.7
Germany	72.4	66.1	57.7
Greece	60.7	48.1	42.3
Ireland	61.9	56.4	50.8
Italy	57.8	46.1	36.6
Netherlands	76.0	69.4	54.1
Portugal	70.0	61.1	49.2
Spain	59.9	53.0	43.6
United Kingdom	72.4	65.3	56.7
United States	69.8	62.4	60.3
OECD countries	67.3	56.7	54.0

Source: OECD.
1/ Percent of working age population.
2/ Percent of female population (15-64)
3/ Percent of population aged (55-64)

23. **Reform of labor and business income taxation would improve incentives for employment and growth**. Lowering the labor tax wedge, which remains high on average relative to the OECD countries, could increase labor demand, while preventing higher wage claims by unions. Reforms of the tax-benefit system targeting work incentives to the high labor supply margins—senior workers and women with school-age children—are expected to be effective and cost-efficient.[16] [17] Notwithstanding the already-existing social benefit RSA ("Revenu de Solidarité Active") and tax credit PPE ("Prime pour l'emploi") that encourage labor supply, more generous earned income tax credits and special credit for social security contributions paid for these groups of workers could be considered. A corporate tax reform, through lowering the statutory rate along with base broadening and reducing complexity, would help to make the system fairer and simpler and make the corporate tax system less biased against small firms, which are often the source of innovation and job creation. Reducing the relatively large bias toward debt financing from interest deductibility would reduce banks' excess leverage and promote greater reliance on equity finance which could ultimately boost innovative investments.

[16] While the employment rate of prime-aged women (30–54 years) has increased in line with that of other OECD countries, French women's average hours worked have declined markedly since the late 1970s.

[17] See Poirson (2011, "Toward a Growth-Oriented Tax System for France") for more details.

C. Toward an Upside Scenario

24. **The following policy elements will be explored in an upside scenario:**

- *Additional fiscal consolidation to put public finances on a sustainable track*. Despite the fiscal measures announced in August 2011, on account of revised growth projections, additional measures of about 0.4 percent of GDP are needed to meet the Toronto commitment of halving the deficit by 2013, and further fiscal consolidation (over 1 percent of GDP by 2016) would be needed to achieve fiscal sustainability as targeted in the Stability Program. The consolidation could be financed by expenditure cuts and additional revenue measures (roughly 2 to 1 in favor of expenditure cuts), including through an increase in VAT revenue.

- *Tax reform to reduce distortions and raise potential output*. Corporate income tax (CIT) could be lowered to raise investment and potential output. Labor taxation could also be reduced to increase labor participation. These tax and social security contribution cuts could be financed with further increases in VAT revenue and a cut in tax expenditures.

- *Structural reforms to boost productivity in nontradables together with wage moderation*.[18] Product market reforms to boost productivity, particularly in services, could include convergence of regulation in network industries, retail trade, and professional services to best practice. Additional labor market reforms and minimum wage moderation are also crucial to improve productivity and reduce unemployment (notably of the young and low-skilled workers).

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[18] The structural reform scenario was developed in close partnership with the OECD, which provided estimates of the impact of structural reforms on productivity.