The governance of public finances: from the Fiscal pact to France’s Organic law

by Henri Sterdyniak

So the French government has had Parliament enact an “Organic law relating to the planning and governance of public finances” (*loi organique relative à la programmation et à la gouvernance des finances publiques)*, which translates into French law the European Fiscal pact (the Treaty on stability, coordination and governance) that France had made a commitment to ratify. This Law can be assessed from two points of view: from the perspective of how well it conforms to the Treaty or from the viewpoint of its own relevance, *i.e.* will it improve France’s fiscal policy?

In fact, the government has chosen – as the Constitutional Council had provided it with the possibility of so doing – a minimalist approach to taking into account the Treaty. The new budgetary procedure is not incorporated into the Constitution, and as we shall see, the Treaty provides for certain automatic binding procedures that the Organic law tempers or does not mention.

The Organic Law has three sections, dealing respectively with the budget plan (*loi de programmation des finances publiques – LPFP*), the High Council on the Public Finances (*Haut Conseil des finances publiques*), and a correction mechanism.

The Budget Plan

Article 1 of the Organic Law stipulates: “In accordance with the objective of balanced government accounts as set out in Article 34 of the Constitution, the LPFP sets the medium-term targets of the government administrations referred to in

Article 3 of the TSCG.”

Article 34 of the Constitution, adopted on 31 July 2008, set out only a medium-term non-binding target. It has had little influence on the fiscal policy adopted since then. In times of crisis, the multi-year guidelines quickly cease to have an influence. This was the case, for example, in 2009. The 2009 deficit, which was set at 0.9% of GDP by the four-year budget plan passed in January 2008, and 3.9% of GDP according to the January 2009 plan, ultimately amounted to 7.5%. Should we give up this flexibility?

Moreover, how can the budget plan “set a target” when the target flows from Article 3 of the Treaty, which clearly states that the target should be a structural deficit of less than 0.5% of GDP and that a path for an adjustment to ensure a rapid convergence toward equilibrium will be proposed by the European Commission?

Doesn’t the ambiguity of this article actually reflect an attempt to reconcile the irreconcilable: the sovereignty of Parliament in budgetary matters with France’s commitment to follow the recommendations of the Commission?

Article 1 of the Organic Law continues: “The budget plan (LPFP) determines the trajectory of the successive annual actual balances and structural balances… The structural balance is the cyclically-adjusted balance net of one-off and temporary measures.” Article 3 states that the period covered is at least three years.

Thus, the Law takes no account of the experience of the Stability and Growth Pact (SGP): it is impossible to fix a trajectory for the public finances, in terms of the structural and actual deficit, for a period of three years. In January 2008, France was committed to having a balanced budget in 2012. It won’t even get close. Should commitments be made that are impossible to keep?

This is impossible for two reasons. First, unpredictable economic fluctuations make it necessary to constantly adapt economic policy. In case of a deep crisis, as since 2009, it is necessary to make use of both economic stabilizers and discretionary measures (which increase what is called the structural deficit). If taken seriously, the Treaty prohibits any policy to boost activity during a downturn in activity. In the autumn of 2008, according to the Commission France had a structural deficit of 3.2% of GDP. If the Treaty had been in force, it would have had to reduce this quickly to 2.5% in 2009. In fact, France has moved to a structural deficit of 6% of GDP, according to the Commission's assessment, in other words, 3.5 percentage points higher. Is the government wrong to have promoted activity, or to have come to the rescue of the banks? Should it have embarked on a tough austerity policy to offset the fall in tax revenue?

The text is, of course, ambiguous. On the one hand, it sets out that the structural deficit does not include "one-off and temporary" measures. Assistance to banks is undoubtedly a one-off, but why not all the 2009 stimulus measures, or in the opposite direction, the 75% income tax assessment which is scheduled for 2 years? Who decides? On the other hand, the Treaty recognizes that a country may deviate from its target or its adjustment path in the event of "exceptional circumstances" which, since the revision of the Growth and Stability Pact, can be interpreted as negative growth or a large output gap. However, the Commission refuses to recognize that most euro zone countries have actually been in this situation since 2009, and it is insisting on imposing rapid deficit reduction policies on them.

On the other hand, a State has no economic reason to set itself a standard for balancing the public purse. According to the true "golden rule of public finance", which was stated by the economist Paul Leroy-Beaulieu in the late nineteenth century, it is legitimate to finance public investment through debt. In the case of France, a structural deficit of around 2.4% of GDP is legitimate.

As in the Treaty, Article 1 of the Organic Law refers to the structural balance, the balance that would exist if France were at its potential output, the maximum output consistent with stable inflation. But the size of this potential output, which cannot simply be observed, is a subject of debate among economists. Different methods produce different results, which are subject to sharp revisions. France's structural balance in 2012 is 3.6% according to the French government, 3% according to the European Commission, 2.8% according to the OECD, and according to us 0.5%, since the crisis has caused us to lose 8% of GDP compared to our growth trend. The Treaty requires the use of the Commission's method. Is this scientifically legitimate? Can France call into question this assessment?

Article 5 states that the potential growth assumptions should be presented in an appendix, but the definition of potential growth is even more questionable than that of potential output. For example, the latest budget bill (*projet de loi de finances – PLF*) expects potential growth of 1.5% per year up to 2017 for France, thus abandoning forever the expectation of making up the 8 points of activity lost to the crisis.

The Organic Law simply forgets Article 4 of the Treaty (which requires a country with a debt of over 60% of GDP to reduce the gap by one-twentieth per year). It also ignores Article 5, which states that a country subject to an Excessive Deficit Procedure (EDP) is to be placed under supervision, and has to submit to the EU Council and Commission annual budget plans and a list of the structural reforms that it will implement in order to make a sustainable correction to its deficit. It is this article that obliges France, like many other EU countries, to do all it can to get down to a 3% deficit by 2013, regardless of the economic situation, since, in case of an EDP, the constraint pertains to the actual balance and not the structural balance. It forgets Article 7, which states that, in this context, the decisions of the Commission are obligatory (member countries can oppose it only with a qualified majority, with the country concerned not voting).

The LPFP will cover a period of four to five years, but will be voted upon again each year, so that the constraint thus introduced can be changed by a vote on a new budget plan. This has been the case in France for as long as the Fiscal Pact has existed. Thus, the LPFP does not introduce any supplementary constraint itself, other than what is already required by European legislation.

The High Council of Public Finance

The Organic Law sets up a High Council of Public Finance, which will advise on the macroeconomic forecasts underlying the budget bill (LPF), the bill financing social security, the adjustment budget bills, the stability program that France must provide to the European authorities, and the budget plan (LPFP). It will assess whether France has been meeting its European commitments, and verify that the LPF (budget bill) is consistent with the trajectory announced in the budget plan (LPFP). It will give its opinion on any evocation of "exceptional circumstances".

Chaired by the President of France's Court of Audit (Cour des comptes), the High Council consists of four members from the Court of Audit and four members appointed for their expertise in public finance by the Presidents of the National Assembly, the Senate and the two finance commissions. This predominance of the Court of Audit is problematic. The judicial officers from the Court of Audit are not *a priori* experts in macroeconomics, and they are often, based on their function, more concerned with balancing the public finances than with growth and employment. For instance, the latest reports from the Court of Audit underestimate the output gap, support the thesis that the fiscal multiplier is close to zero, and believe that it is better to reduce public spending than to increase taxes. We would like to be certain that the composition of the High Council and its work and reports reflect the diversity of opinion that exists on fiscal policy.

More fundamentally, it is questionable whether the High Council has room for flexibility in its assessments. Will it have the right to conclude that the path of adjustment is too restrictive, and that the medium-term objective is not realistic? What strategy will be advocated by the High Council in the event of an economic slowdown: an expansionary policy to support growth or an austerity policy to restore the public finances?

Assume, for example, that the government has a budget for 2013 based on growth of 1.2%, resulting in a deficit of 3%. The High Council believes that growth will instead be only 0.6%, causing a decline in tax revenues, and thus a deficit of 3.3%. It will advocate doing whatever is necessary to achieve a 3% deficit. Assuming that the fiscal multiplier is 1, it will be necessary to come up with 12 billion in tax increases (or spending cuts), or 0.6% of GDP, to have an *ex post* deficit of 3%, but no growth. There is thus a great risk that this will lead to pro-cyclical policies. This will of course be mitigated when France is longer be subject to an EDP, as the High Council can then reason in terms of the structural deficit, but this will persist because everything will then depend on evaluating the structural deficit.

Lastly, there is the question of what legitimacy the High Council will have. The choice of fiscal policy must be subject to democratic procedures. The assessment of economic policy is part of a scientific, democratic debate. Should it be entrusted to a High Council, composed mainly of judicial experts, rather than economists on the one hand and representatives of the nation on the other?

The High Council will of course only give advice, which neither the government nor parliament are obliged to follow, but the risk is great that these opinions will affect the financial markets and the Commission and that it would be risky for the government to ignore them.

The correction mechanism

To ensure that countries do indeed follow the adjustment path, the Treaty requires countries to provide an automatic correction mechanism if deviations are observed with respect to this path. In the minds of the negotiators of the North European countries and members of the Commission, this mechanism should provide that if a deviation of 1% of GDP is seen in year N, the Constitution provides that, automatically, a certain tax (*e.g.* VAT) would be raised by 0.5 GDP point and certain expenditures (*e.g.* social benefits) would be reduced by 0.5 GDP point.

In fact, Chapter 3 of France’s Organic Law provides that the High Council is to report such a gap, the government is to set out the reasons for this discrepancy and then take it into account in drawing up the next budget bill. Parliament’s rights are respected, but fortunately the character of being automatic is not guaranteed.

Conclusion

In the spirit of its founders, the fiscal treaty must put an end to the possibility of autonomous national fiscal policies. Fiscal policies should become automatic. The goal of fiscal policy should be balancing the budget, just as the goal of monetary policy should be fighting inflation; growth and employment are to be sought by means of free market structural reforms.

The Organic Law seems to be an ambiguous compromise. France is ratifying the Treaty, but implementing it only reluctantly. It’s a safe bet that, as with the Stability Pact, there will be great tension in the euro zone between purists who demand the strict application of the Treaty and those who do not want to sacrifice growth to it.