Must balancing the public finances be the main goal of economic policy

By Henri Sterdyniak

The financial crisis of 2007-2012 caused a sharp rise in public deficits and debt as States had to intervene to save the financial system and support economic activity, and especially as they experienced a steep drop in tax revenues due to falling GDP. In early 2012, at a time when they are far from having recovered from the effects of the crisis (which cost them an average of 8 GDP points compared to the pre-crisis trend), they face a difficult choice: should they continue to support activity, or do whatever it takes to reduce public deficits and debt?

An in-depth note expands on nine analytical points:

– The growth of debt and deficits is not peculiar to France; it occurred in all the developed countries.

– France's public bodies are certainly indebted, but they also have physical assets. Overall the net wealth of government represented 26.7% of GDP in late 2010, or 8000 euros per capita. Moreover, when all the national wealth is taken into account (physical assets less foreign debt), then every French newborn has an average worth at birth of 202 000 euros (national wealth divided by the number of inhabitants).

– In 2010, the net debt burden came to 2.3% of GDP, reflecting an average interest rate on the debt of 3.0%, which is well below the nominal potential growth rate. At this level, the real cost of the debt, that is, the primary surplus needed to stabilize the debt, is zero or even slightly negative.

– The true “golden rule” of public finances stipulates that it is legitimate to finance public investment by public borrowing. The structural deficit must thus be equal to the net public investment. For France, this rule permits a deficit of around 2.4% of GDP. There is no reason to set a standard for balancing the public finances. The State is not a household. It is immortal, and can thus run a permanent debt: the State does not have to repay its debt, but only to guarantee that it will always service it.

– The public deficit is detrimental to future generations whenever it becomes destabilizing due to an excessive increase in public spending or an excessive decrease in taxation, at which point it causes a rise in inflation and interest rates and undermines investment and growth. This is not the situation of the current deficit, which is aimed at making adjustments to provide the necessary support for economic activity in a situation of low interest rates, due to the high level of household savings and the refusal of business to invest more.

– For some, the 8 GDP points lost during the crisis have been lost forever; we must resign ourselves to persistently high unemployment, as it is structural in nature. Since the goal must be to balance the structural public balance, France needs to make an additional major effort of around 4 percentage points of GDP of its deficit. For us, a sustainable deficit is about 2.4 GDP points. The structural deficit in 2011 is already below that figure. It is growth that should make it possible to reduce the current deficit. No additional fiscal effort is needed.

– On 9 December 2011, the euro zone countries agreed on a new fiscal pact: the Treaty on Stability, Coordination and Governance of the European Monetary Union. This Pact will place strong constraints on future fiscal policy. The structural deficit of each member country must be less than 0.5% of GDP. An automatic correction mechanism is to be

triggered if this threshold is exceeded. This constraint and the overall mechanism must be integrated in a binding and permanent manner into the fiscal procedures of each country. Countries whose debt exceeds 60% of GDP will have to reduce their debt ratio by at least one-twentieth of the excess every year.

This project is economically dangerous. It imposes medium-term objectives (a balanced budget, a debt rolled back to below 60% of GDP) that are arbitrary and are not *a priori* compatible with the necessities of an economic equilibrium. Likewise, it imposes a fiscal policy that is incompatible with the necessities of short-term economic management. It prohibits any discretionary fiscal policy. It deprives governments of any fiscal policy instrument.

– As the rise in public debts and deficits in the developed countries came in response to mounting global imbalances, we cannot reduce the debts and deficits without addressing the causes of these imbalances. Otherwise, the simultaneous implementation of restrictive fiscal policies in the OECD countries as a whole will lead to stagnating production, falling tax revenues and deteriorating debt ratios, without managing to reassure the financial markets.

– A more balanced global economy would require that the countries in surplus base their growth on domestic demand and that their capital assumes the risks associated with direct investment. In the Anglo-American world, higher growth in wage and social income and a reduction in income inequalities would undercut the need for swelling financial bubbles, household debt and public debt. The euro zone needs to find the 8 GDP points lost to the crisis. Instead of focussing on government balances, the European authorities should come up with a strategy to end the crisis, based on a recovery in demand, and in particular on investment to prepare for the ecological transition. This strategy must include keeping interest rates low and public deficits at the levels needed to support

activity.

Is government expenditure in France too high?

By Xavier Timbeau

Since 2005, France has vied with Denmark for first place in terms of government expenditure as reported by the OECD. Since the ratio of “government expenditure” to GDP reached 56.6% in 2010, it has been necessary, according to a widely held view, to “deflate” a State that is taking up “too much” space in the economy. First place would thus be, not a badge of honour, but a sign that we have reached an unsustainable level of “government expenditure”. Since, moreover, it is essential to reduce the public deficit, the path ahead is clear: reducing public spending is the only way to bring public finances under control. But this simplistic analysis is wrong.

This analysis is based on a poor use of the statistics on government expenditure reported by the OECD and flows from an inadequate understanding of what the term “government expenditure” means. This term, it must be recognized, can be confusing.

What is called “government expenditure” combines, on the one

hand, collective expenditures (*e.g.* from maintenance of the security forces to public administration and the fight against poverty) and, on the other, insurance-related transfer expenditures. This transfer spending covers pension insurance and health insurance. These are individualizable in the sense that we know the direct beneficiary of the expense (which is not the case for administrative expenditures, for which the benefits are diffuse), and they are funded by contributory schemes: to qualify for coverage, it is necessary to have contributed. In most countries, the pension system is almost completely contributory, in the sense that the relative level of benefits for individuals of the same age is related to their relative contributions. The rate of return on the contributions (which relates the expected present value of the flow of pension benefits to the present value of the contributions) is comparable to that obtainable over a long period by capitalizing savings. The minimum pension payment, family benefits and survivor benefits might seem to deviate from this contributory principle, but in practice these "benefits" compensate for short careers that have been interrupted by the accidents of life and do not differ much from a contributory scheme. With regard to health, another pillar of the modern welfare State, the contributory aspect is mitigated by the redistribution effected by a contribution that is proportional to income and an expense that depends on age and not much on income (with the exception of daily allowances). When health care provision is universal, some people benefit without having contributed, but these cases are marginal and do not alter the quasi-contributory character of our health systems.

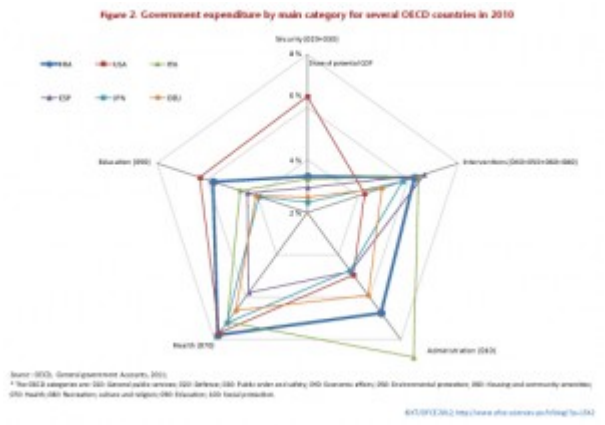
Depending on the country, the pooling of transfer expenditures takes various organizational forms. It may be done inside the company, within sector-wide organizations, or by management and trade union bodies or it may be mediated by central government. The particularity of France is that social protection is mainly organized through the State's

intermediation. This is not the case in other countries like the United Kingdom, the United States or Germany. Even unemployment insurance, which is handled by management/union bodies, is treated by the national accounts as pertaining to the public sector, and UI contributions are considered compulsory levies (automobile insurance premiums, although imposed on anyone who uses the roads, are not classed as levies).

Figure 1 shows the unique position of France. In 2010, “government expenditure” in the strict sense (that is to say, not individualizable, such as domestic and foreign security, administration, miscellaneous expenditure on interventions) represented 18.2% of the country’s GDP. In terms of this “strict government expenditure”, in 2009 France ranked 10th among the OECD countries (see also Figure 2). If the “competition for being thin” covered only expenditure in this narrower sense, France would be relatively average compared to other bigger-spending countries like the United States, Portugal and Italy. Moreover, unlike the UK, the US or Ireland, over the last 20 years France has cut “strict government expenditure”, in a rather unexpected demonstration of fiscal control.

Figure 1 also shows that there is not great variation among the OECD countries with respect to the hard core of “government expenditure”. A developed country needs security, public administration and expenditure on interventions. It is difficult to compress this kind of State spending; the

difference between the State with the largest expenditure (Hungary) and that with the smallest (Switzerland) is 8 GDP points. If we limit ourselves to large States, the gap is smaller (a difference of 3.6 GDP points between Japan and Italy). In contrast, with respect to “government social expenditure”, the differences between countries are major: the gap between Korea and Denmark is 27 GDP points, and, among the major countries, 13 GDP points between the United States and France. This makes □□France, along with Denmark, Sweden, Austria and Finland, a country where “government social expenditure” in relation to GDP is high.



Can we conclude from these data that the French system of social protection is more generous than in other countries? And that this is the cause of an unsustainable public debt (Figure 3)? Can we say that the system is too generous and that we must reverse the course of the past 20 years by reducing the share of social spending in GDP? No, the data tell us only one thing: that social welfare, health and education in France are dispensed directly by the State, which provides funding for these through the tax system. In other countries, intervention by the State (or by local authorities) may be just as massive (for instance, by defining specifications for education, prices of treatments or medications, or obligations to take out health or retirement insurance), but the performance of the service or the distribution of the benefit may be delegated to a non-public entity. In some countries, only a portion of health or

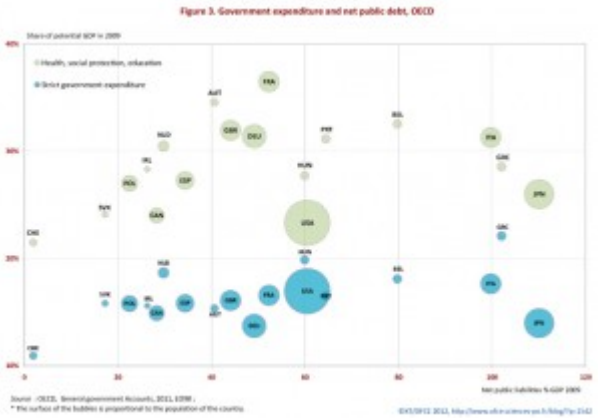
retirement coverage is mandatory, and individuals are then "free" to choose the level of spending they want. This freedom is relative, as people can be steered by tax incentives (instead of "government expenditure", we speak of a "tax expenditure", since it implies a shortfall in tax revenue for the State) or by necessity.

Total spending on health care and education is, for example, higher in the US than it is in France, relative to GDP, although the share directly distributed by the State is lower. How is it that expenditures deemed characteristic of a welfare State are higher in a more individualistic society? Are tax incentives and social norms being taken sufficiently into account? Another example: the introduction of the premium and the discount (*surcote* and *décote*) into the French pension system has changed individual incentives, and therefore individual returns (towards greater "actuarial neutrality"). But this did not affect the GDP share of "government expenditure" on pensions. In the future, the establishment of long-term care insurance may increase "government social expenditure" by a few GDP points. The right question is not the legal personality of the distributing entity, but rather, what are the incentives that individuals perceive, and what kind of inter- or intra-generational support will this long-term care insurance involve.

A social system must be judged on the rights it confers and the duties it entails, and thus on the extent to which it is more contributory or more solidarity-oriented and redistributive. To this end, we need to look at the benefits and the levies, as well as the implicit or explicit guarantees given in case of a shock to the private or public institutions that provide the benefits. A private system can be very redistributive (when the pricing of certain risks is prohibited, when there is a full State guarantee), and a public system can be very contributory and more neutral from an intergenerational perspective than a private system, as

illustrated by Swedish pensions.

A simple review of the aggregate data is not enough to settle this debate, which is why the argument that cutting "government social expenditure" on the grounds that it is higher than in any other country simply makes no sense.



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Figures_government expenditures

He who sows austerity reaps recession

By the Department of Analysis and Forecasting, headed by X. Timbeau

This article summarizes OFCE note no.16 that gives the outlook on the global economy for 2012-2013.

The sovereign debt crisis has passed its peak. Greece's public debt has been restructured and, at the cost of a default, will fall from 160% of GDP to 120%. This restructuring has

permitted the release of financial support from the Troika to Greece, which for the time being solves the problem of financing the renewal of the country's public debt. The contagion that hit most euro zone countries, and which was reflected in higher sovereign rates, has been stopped. Tension has eased considerably since the beginning of 2012, and the risk that the euro zone will break up has been greatly reduced, at least in the short term. Nevertheless, the process of the Great Recession that began in 2008 being transformed into a very Great Recession has not been interrupted by the temporary relief of the Greek crisis.

First, the global economy, and especially the euro zone, remains a high-risk zone where a systemic crisis is looming once again. Second, the strategy adopted by Europe, namely the rapid reduction of public debt (which involves cutting public deficits and maintaining them below the level needed to stabilize debt), is jeopardizing the stated objective. However, since the credibility of this strategy is perceived, rightly or wrongly, as a necessary step in the euro zone to reassure the financial markets and make it possible to finance the public debt at acceptable rates (between 10% and 20% of this debt is refinanced each year), the difficulty of reaching the goal is demanding ever greater rigor. The euro zone seems to be pursuing a strategy for which it does not hold the reins, which can only fuel speculation and uncertainty.

Our forecast for the euro zone points to a recession of 0.4 percentage point in 2012 and growth of 0.3 point in 2013 (Table 1). GDP per capita in the euro zone should decline in 2012 and stabilize in 2013. The UK will escape recession in 2012, but in 2012 and 2013 annual GDP growth will remain below 1%. In the US, GDP growth will accelerate from 1.7% per year in 2011 to 2.3% in 2012. Although this growth rate is higher than in the euro zone, it is barely enough to trigger an increase in GDP per capita and will not lead to any significant fall in unemployment.

The epicenter of the crisis is thus shifting to the Old Continent and undermining the recovery in the developed

countries. The United States and United Kingdom, which are faced even more than the euro zone with deteriorating fiscal positions, and thus mounting debt, are worried about the sustainability of their public debts. But because growth is just as important for the stability of the debt, the budget cuts in the euro zone that are weighing on their activity are only adding to difficulties of the US and UK.

By emphasizing the rapid reduction of deficits and public debt, euro zone policymakers are showing that they are anticipating a worst case scenario for the future. Relying on so-called market discipline to rein in countries whose public finances have deteriorated only aggravates the problem of sustainability by pushing interest rates up. Through the interplay of the fiscal multiplier, which is always underestimated in the development of strategies and forecasts, fiscal adjustment policies are leading to a reduction in activity, which validates the resignation to a worse “new normal”. Ultimately, this is simply a self-fulfilling process.

Should the Stability and Growth Pact be strengthened?

By Jérôme Creel, Paul Hubert and Francesco Saraceno

The European fiscal crisis and the ensuing need to reduce the levels of public debt accelerated the adoption of a series of reforms of European fiscal rules in late 2011. Two rules were introduced to strengthen the Stability and Growth Pact (SGP). Given that many Member States in the euro zone have structural deficits and public debts that exceed the thresholds under consideration, it seemed worthwhile to assess the macroeconomic implications of compliance with these fiscal rules by four countries, including France.

The current limit of the public deficit to 3% of GDP was supplemented by a limit on the structural deficit equivalent to 0.5% of GDP, and by a rule on debt reduction requiring heavily indebted countries to reduce their level of public debt every year by 1/20th of the difference with the reference level of 60% of GDP. Moreover, the limit on the structural deficit goes beyond the 3% rule because it is associated with a requirement to incorporate a balanced budget rule and automatic mechanisms for returning to balanced budgets in the constitution of each Member State in the euro zone. Due to an unfortunate misnomer, this is now often called the "golden rule" [1]. To distinguish this from the "golden rule of public finance" applied by the French regions, the German Länder and, from 1997 to 2009, the UK, we will henceforth call this "balanced budget rule" the "new golden rule ".

Because of the international financial crisis raging since 2007, the euro zone States often fall far short of the demands of the new rules. This raises the question of the consequences that flow from imposing these rules on the Members. To this end, we decided to study the paths of convergence with the different rules of four countries that are representative of the euro zone, using a standard theoretical model.

We chose a large country with an average level of public debt (France), a small country with a somewhat larger debt (Belgium), a large country with a large debt (Italy) and a small country with a relatively low level of debt (Netherlands). The size of the country, large or small, is associated with the size of their fiscal multiplier, i.e. the impact of public spending on growth: large countries that are less open than the small countries to international trade have a greater multiplier effect than the small countries. The four countries also differed with respect to the size and sign of their structural primary balance in 2010: France and the Netherlands ran a deficit, while Belgium and Italy had a surplus.

In the model, the evolution of the public deficit is countercyclical and the impact of an increase in the public deficit on GDP is positive, but excessive indebtedness increases the risk premium on the long-term interest rates paid to finance this debt, which ultimately undermines the effectiveness of fiscal policy.

The rules that we simulated are: (a) a balanced (at 0.5% of GDP) budget or the “new golden rule”; (b) the 5% per year rule on debt reduction; (c) the 3% ceiling on the total deficit (status quo). We also evaluated: (d) the impact of adopting an investment rule along the lines of the golden rule of public finance which, in general, requires a balanced budget for current expenditure over the cycle, while allowing the debt to finance public investment.

We simulated over 20 years, i.e. the horizon for implementing the 1/20th rule, the impact of the rules on growth, on the inflation rate and the structural public deficit and on the level of public debt. First, we analyzed the path followed by the four economies after the adoption of each fiscal rule in 2010. In other words, we asked how the rules work in the context of the fiscal austerity that Europe is currently experiencing. Second, we simulated the dynamics of the economy after a demand shock and a supply shock, starting from the base situation of the Maastricht Treaty, with the economy

growing at a nominal rate of 5% (growth potential of 3% and inflation rate of 2%), and a debt level of 60%. It is interesting to note that the real growth potential in the euro zone countries has been consistently below 3% since 1992, which has helped to make the rule limiting public finances even more restrictive than originally planned.

Our simulations led to a number of results. First, in every case the adoption of the rules produced a short-term recession, even in small countries with a small fiscal multiplier and a small initial public debt, such as the Netherlands. This complements the analysis that the widespread implementation of austerity in Europe is inevitably undermining growth (see The very great recession, 2011) by showing that there is no fiscal rule that, strictly applied in the short term, makes it possible to avoid a recession. This finding points to an incentive on the part of government to dissociate the use of the fiscal rules de facto and de jure: in other words, if the ultimate goal of economic policy is the preservation and stability of economic growth, then it is wise not to act on the pronouncements.

Second, recessions can lead to deflation. Under the constraint of zero nominal interest rates, deflation is very difficult to reverse with fiscal austerity.

Third, the investment rule leads to a better macroeconomic performance than the other three rules: the recessions are shorter, less pronounced and less inflationary over the time period considered. Ultimately, the levels of public debt decreased admittedly less than with the 1/20th rule but, as a result of the growth generated, France's public debt shrinks by 10 GDP points from its 2010 level, while the Belgian and Italian debt are reduced by 30 and 50 GDP points, respectively. Only the country that was least indebted initially, the Netherlands, saw its debt stagnate.

Fourth, while ignoring the investment rule, which is not part of European plans, it appears that, in terms of growth, the status quo is more favorable than the "new golden rule" or the rule on debt reduction; it is, however, more inflationary for

the large countries. This indicates that, in terms of growth, the strengthening of the Stability and Growth Pact, brutally applied, would be detrimental to the four economies.
Fifth, when the economy in equilibrium is hit by demand and supply shocks, the status quo seems appropriate. This confirms the idea that the current Pact provides room for fiscal maneuvering. The simulations nevertheless suggest that the status quo remains expensive compared with the investment rule.
To conclude, it is difficult not to notice a paradox: the rules designed to prevent governments from intervening in the economy are being discussed precisely after the global financial crisis that required governments to intervene to help cushion the shocks resulting from market failures. This work aims to shift the debate: from the goal of fiscal stabilization to the goal of macroeconomic stabilization. The European authorities – the governments, the ECB and the Commission – seem to consider the public debt and deficit as policy objectives in their own right, rather than as instruments to achieve the ultimate objectives of growth and inflation. This reversal of objectives and instruments is tantamount to denying a priori any role for macroeconomic policy. Many studies [2], including the one we have conducted here, adopt the opposite position: economic policy definitely plays a role in stabilizing economies.

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[1] This misnomer has been criticised in particular by Catherine Mathieu and Henri Sterdyniak in 2011, and by Bernard Schwengler in 2012.
[2] See, for example, the cross-disciplinary study that appeared in English in 2012 in the American Economic Journal, Macroeconomics, and the bibliography that it contains, or in French, the study that appeared in 2011 by Creel, Heyer and Plane on the multiplier effects of temporary fiscal stimulus policies.

The 35 billion euro man

By Henri Sterdyniak

Sarkozy has cost France 500 billion. This is the central point of the book *Un quinquennat de 500 milliards d'euros* [*A 500 billion euro five-year term*] by Melanie Delattre and Emmanuel Levy. According to the authors, out of the 632 billion euro rise in France's debt between late 2006 and late 2011, only 109 billion can be attributed to the crisis, while the remaining 523 billion are the price of the five-year reign of Nicolas Sarkozy. Of this total, 370 billion is said to be due to a failure to correct past mismanagement and 153 billion to wasteful decisions taken during his 5-year term in office. Should we take these figures seriously?

Let's start with an international comparison. From late 2006 to late 2011, the debt of France increased by 21.4 percentage points of GDP, that of the euro zone by 21.5 points, that of the United Kingdom by 40.6 points, and that of the United States by 29.2 points. There is no French specificity, no "Sarkozy effect". France's debt has increased in line with the average for the euro zone, that is to say, by 500 billion euros, representing 20 percent of GDP. Can it be argued that without Sarkozy the country's debt would have been stable as a percentage of GDP, even though it was increasing without him everywhere else?

In fact, according to the government's latest economic report, from late 2006 to late 2012 French public debt will have increased by 620 billion euros. This increase can be broken down as follows: 275 billion from interest payments, 310 billion due to the economic crisis, 30 billion from the stimulus policies implemented in 2009-2010, and 60 billion in

tax reduction policies; but on the other hand, policies restricting public spending (fewer officials, no automatic increase in their wages, rigorous management of social benefits, etc.) has saved 55 billion euros. Sarkozy's responsibility is thus sharply reduced, to at most 35 billion.

The tricky part is measuring the impact of the crisis. To do this, we need to measure the gap between GDP as it has actually evolved and GDP as it would have evolved without the crisis. In our opinion, in the absence of the crisis, GDP would have continued to grow at an annual rate of about 2%. Using this estimate, the loss in output due to the crisis was 6.8% in 2009, which would have caused a tax loss of 4.4% of GDP. The authors use an estimate by the Cour des comptes, which in turn comes from an assessment by the European Commission: the loss of output due to the crisis in 2009 was only 2.8% and the loss of tax revenues was only 1.4%. According to this calculation, the share of the deficit caused by the crisis is relatively low. But this assumes that in 2007-2009 structural GDP declined by 4% from its trend growth. Why? Is this really not linked to the crisis? According to the calculation by the Cour des comptes, the structural decline in GDP caused a significant increase in our structural deficit, which the authors blame on Nicolas Sarkozy. Is this legitimate? Following the Commission's logic, this 4% is lost forever; we must accept this and adjust by reducing the deficit. In our opinion, it would be better to recover this loss through the use of expansionary policies.

In 2006, the year before Nicolas Sarkozy came to power, the public deficit was 2.3%, which was entirely structural. This deficit was "normal" since it ensured debt was stable at 60% of GDP and it corresponded to the volume of public investment. In 2012, with a deficit of 4.5% of GDP, the cyclical deficit is 4.3% of GDP while the structural deficit is only 0.2% of GDP. Overall, from 2006 to 2012 Nicolas Sarkozy will have increased the level of compulsory taxation by 0.7 point (as

the large increases in 2011-12 more than offset the declines in the earlier period) and decreased the share of public expenditure in potential GDP by 1.2 point.

Above all, throughout this entire period, France was in crisis, with a shortfall in demand. An expansionary fiscal policy was necessary to avoid economic collapse. Can we blame Nicolas Sarkozy for the 30 billion euro cost of the stimulus plan? Can we blame him for not having adopted □□a restrictive fiscal policy to “correct past mismanagement”? No, but what we can call into question are the tax cuts that do little for growth (inheritance tax, the *bouclier fiscal* tax cap, overtime) and the cuts in certain vitally needed public expenditures (downsizing staff levels in schools and hospitals, for example).