

Spain: a 2018 budget on target, if the Commission likes it or not

By [Christine Rifflart](#)

With a deficit of 3.1% of GDP in 2017, Spain has cut its deficit by 1.4 points from 2016 and has been meeting its commitments to the European Commission. It should cross the 3% threshold in 2018 without difficulty, making it the latest country to leave the excessive deficit procedure (EDP), after France in 2017. The 2018 budget was first presented to the European Commission on April 30 and then approved by Spain's Congress of Deputies on May 23 amidst a highly tense political situation, which on June 1 led to the dismissal of Spain's President Mariano Rajoy (supported by the Basque nationalist representatives of the PNV Party who had approved the 2018 budget a few days earlier). It should be passed in the Senate soon by another majority vote. The expansionary orientation of the 2018 budget, backed by the government of the new Socialist President Pedro Sanchez, does not satisfy the Commission, which considers the adjustment of public finances insufficient to meet the target of 2.2% of GDP included in the 2018-2021 Stability and Growth Pact (SGP). According to the hypotheses of the previous government, not only would the deficit fall below 3% but the nominal target would be respected.

Admittedly, while, given the strong growth expected in Spain in 2018, the public deficit will easily be below 3% in 2018 and therefore meet the requirements set in the EDP, the new budget act is not in line with the fiscal orthodoxy expected by Brussels. The lack of a People's Party majority in Congress led ex-President Mariano Rajoy into strategic alliances with Ciudadanos and the PNV to get the 2018 budget adopted (with the hope, in particular, of avoiding early parliamentary

elections), at the price of significant concessions:

- An increase in civil servants' salaries of 1.75%[\[1\]](#) in 2018 and at least 2.5% in 2019, with a larger increase if GDP grows by more than 2.5% (estimated cost of 2.7 billion euros in 2018 and 3.5 billion in 2019 according to the outgoing government);
- Lower taxes for low-income households (via the increase in the minimum tax threshold from 12,000 to 14,000 euros income per year, tax credits for childcare expenses, assistance for disabled people and large families, and a reduction in tax on gross wages between 14,000 and 18,000 euros) (cost 835 million in 2018 and 1.4 billion in 2019);
- The revaluation of pensions by 1.6% in 2018 and by 1.5% in 2019 (cost of 1.5 and 2.2 billion), in addition to a rise of up to 3% in the old age and non-taxpayer minimum, and between 1% and 1.5% for the lowest pensions (cost 1.1 billion in 2018).

According to the former government, these measures will cost a little more than 6 billion euros in 2018 (0.5% of GDP) and nearly 7 billion in 2019 (0.6% of GDP). The revaluation of pensions should be partly covered by the introduction of a tax on digital activities (Google tax) in 2018 and 2019, with revenues of 2.1 billion euros expected. In the end, spending, which was expected to fall by 0.9 GDP point in 2018 based on the undertakings made in the previous 2017-2020 SGP, would fall by only 0.5 GDP point in the 2018-2021 SGP (to 40.5% of GDP) (Table). But above all, despite the tax cuts just introduced, the extra revenue expected from the additional growth should represent 0.1 GDP point (to 38.3% of GDP). In fact, the budget's redistributive character, combined with the downward revision of the impact of the Catalan crisis on the economy (0.1% of GDP according to the AIReF [\[2\]](#)) led all the institutes (Bank of Spain, the Government, the European Commission) to raise their 2018 growth forecasts from last winter by 0.2 or 0.3 GDP point to bring it slightly below 3%

(2.6% for the OFCE according to our April forecasts [\[3\]](#)).

Table. Breakdown of Spanish public finances

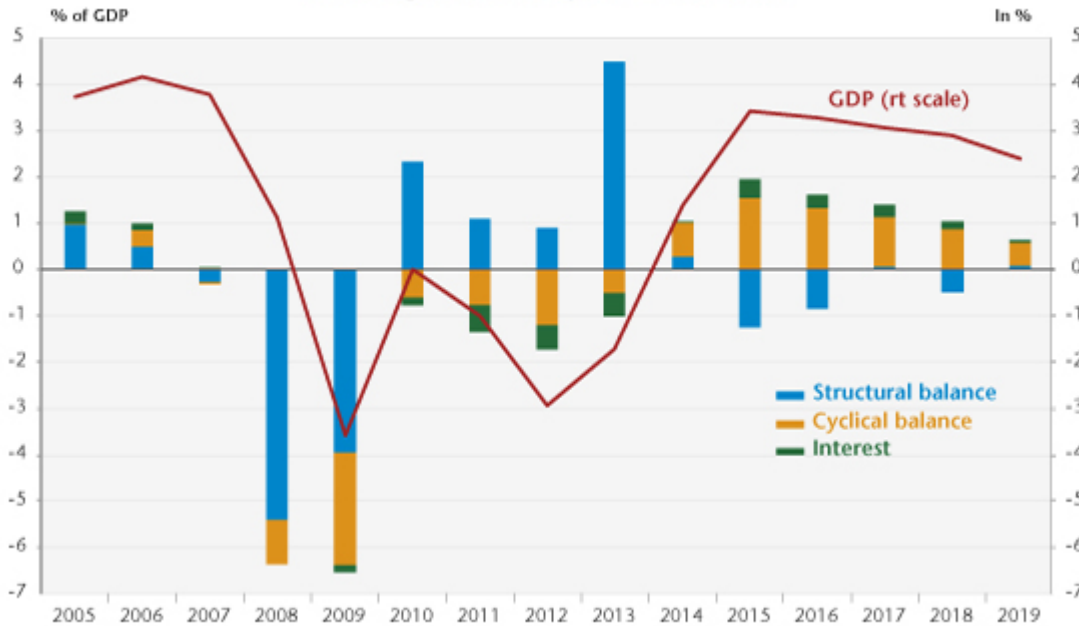
% of GDP	2017			2018			2019*		
	Gvt	EC	OFCE	Gvt	EC	OFCE	Gvt	EC	OFCE
GDP	3.1	3.1	3.1	2.7	2.9	2.6	2.4	2.4	1.9
Potential GDP	1.0	1.0	0.9	1.0	1.2	1.1	1.3	1.4	1.1
Output gap	-1.6	-0.2	-2.9	0.1	1.4	-1.4	1.2	2.3	-0.6
Budget balance	-3.1	-3.1	-3.1	-2.2	-2.6	-2.3	-1.3	-1.9	-1.5
Revenue	37.9	37.9		38.3	38.1		38.5	38.1	
Spending	41.0	41.0		40.5	40.7		39.8	40.0	
Cyclical balance	-0.8	-0.1	-1.5	0.0	0.8	-0.7	0.6	1.3	-0.3
Interest	2.6	2.6	2.6	2.4	2.4	2.4	2.3	2.4	2.3
Primary balance adjusted for cycle	0.3	-0.4	1.0	0.2	-1.0	0.8	0.4	-0.8	1.1

* In 2019, the cyclically-adjusted primary balance should improve by 0.2 GDP point due to the elimination of exceptional measures, estimated by the government at 0.2 GDP point.

Sources: European Commission; OFCE – April 2018 forecasts.

Nevertheless, beyond the shared optimism about Spanish growth, the calculations of the cost of the new measures differ between the Spanish authorities and the Commission. According to the government, the increase in growth should, as we have said, boost tax revenues and neutralize the expected cost of new spending. In 2018, the 0.9 percentage point reduction in the deficit (from 3.1% to 2.2%) would therefore be achieved by the 0.8 GDP point growth in the cyclical balance, combined with the 0.2 point fall in debt charges, with the structural balance remaining stable (fiscal policy would become neutral rather than restrictive as set out in the earlier version of the Pact). But this scenario is not shared by Brussels[\[4\]](#), for whom the cost of the measures, and in particular of the increase in civil servants' salaries, is underestimated. Expenditures are expected to be 0.2 GDP point higher and revenue 0.2 GDP point higher than the government has announced. According to the Commission, the cyclical balance is expected to improve by 0.9 GDP point, but the fiscal impulse would worsen the structural balance by 0.6 GDP point. In these conditions, the deficit would bypass the 3% mark, but fiscal policy would clearly become expansionary and the 2.2% target would not be hit. The public deficit stood at 2.6% in 2018 (Figure 1).

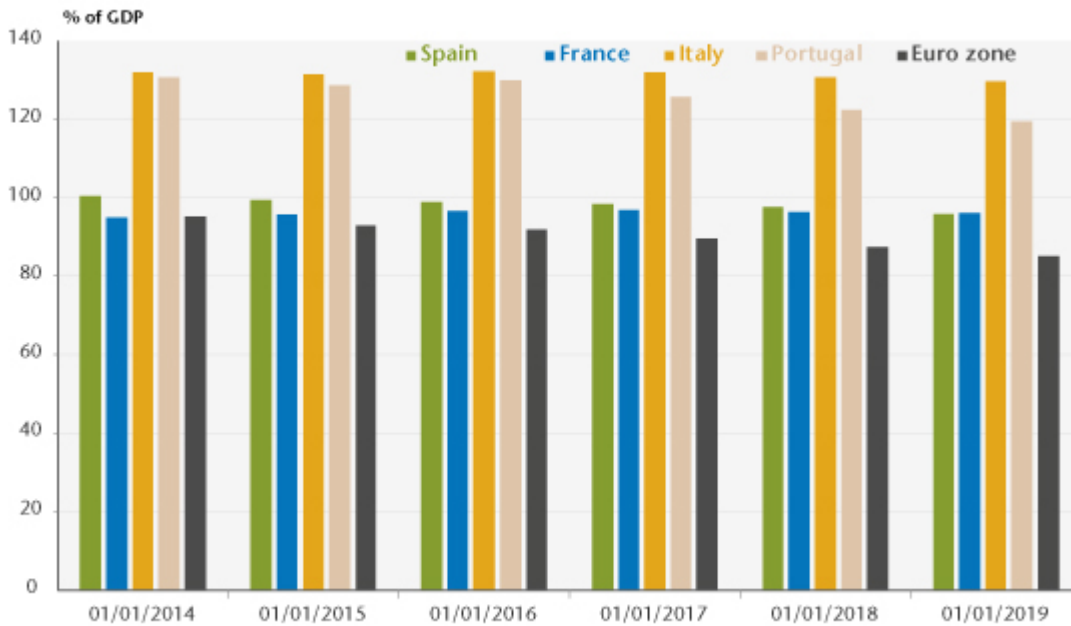
Figure 1. Breakdown of the public balance, as % of GDP, according to the European Commission



Source: European Commission.

This more expansionary orientation of the 2018 budget results above all from the political considerations of the former Rajoy government and its effort to deal with the impossibility of governing (facts have demonstrated the fragility of this position). Nevertheless, the timing is ideal – because the only budget commitment required in 2018 is to cross the 3% deficit threshold in order to get out of the corrective arm of the SGP. The year 2018 therefore makes it possible to implement a generous fiscal policy, while crossing the 3% mark, without exposing the country to sanctions. The situation will be more delicate in 2019, when EU rules aimed at reducing a debt that is still well above 60% of GDP will be applied, notably by adjusting the structural balance (Figure 2).

Figure 2. The public debt in the euro zone



Source: European Commission.

[1] <https://www.boe.es/boe/dias/2018/03/26/pdfs/B0E-A-2018-4222.pdf>

[2] https://elpais.com/economia/2018/04/17/actualidad/1523949570_477094.html?rel=str_articulo#1526464987471

[3] See the Spain part of the dossier: <https://www.ofce.sciences-po.fr/pdf/revue/11-1550FCE.pdf> , pp 137-141.

[4] Nor by the AIReF.

Trump's budget policy:

Mortgaging the future?

By [Christophe Blot](#)

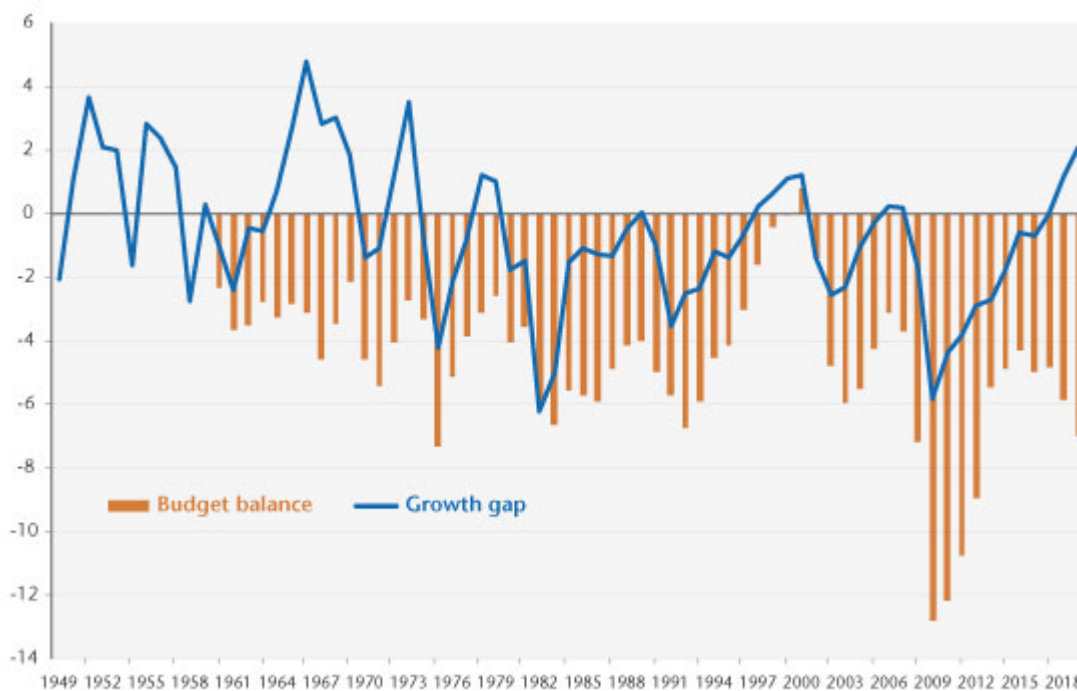
While the momentum for growth has lost steam in [some countries](#) – Germany, France and Japan in particular – GDP in the United States is continuing to rise at a steady pace. Growth could even pick up pace in the course of the year as a highly expansionary fiscal policy is implemented. In 2018 and 2019, the fiscal stimulus approved by the Trump administration – in December 2017 for the revenue component, and in February 2018 for the expenditure side – would amount to 2.9 GDP points. This level of fiscal impulse would come close to that implemented by Obama for 2008. However, Trump's choice has been made in a very different context, since the unemployment rate in the United States fell back below the 4% mark in April 2018, whereas it was accelerating 10 years ago, peaking at 9.9% in 2009. The US economy should benefit from the stimulus, but at the cost of accumulating additional debt.

Donald Trump had made fiscal shock one of the central elements of his presidential campaign. Work was begun in this direction at the beginning of his mandate, and came to fruition in December 2017 with the passing of a major tax reform, the Tax Cuts and Jobs Act [\[1\]](#), which provided for a reduction in household income tax – in particular by reducing the maximum marginal income tax rate – and corporation tax, whose effective rate would fall from 21% to 9% by 2018 [\[2\]](#). In addition to this initial stimulus, expenditure will also rise in accordance with the agreement reached with the Democrats in February 2018, which should lead to [raising federal spending](#) by USD 320 billion (1.7 GDP points) over two years. These choices will push up domestic demand through boosting household disposable income and corporate profitability, which should stimulate consumption and investment. The multiplier effect – which measures the impact on GDP of a one dollar increase in public spending or a one dollar cut in taxes –

will nevertheless be relatively small (0.5) because of the US position in the cycle.

Moreover, the public deficit will expand sharply, to reach a historically high level outside a period of crisis or war (graph). It will come to 5.8% of GDP in 2018 and 7.0% in 2019, while the growth gap will become positive [\[3\]](#). While the risk of overheating seems limited in the short term, the fact remains that the fiscal strategy being implemented could push the Federal Reserve to tighten monetary policy more quickly. However, an excessive rise in interest rates in a context of high public debt would provoke a snowball effect. Above all, by choosing to re-launch the economy in a favourable environment, the government risks being forced to make adjustments later when the economic situation deteriorates. This pro-cyclical stance in fiscal policy risks amplifying the cycle by accelerating growth today while taking the risk of accentuating a future slowdown. With a deficit of 7% in 2019, fiscal policy's manoeuvring room will actually shrink.

Figure. A pro-cyclical budget policy



Sources: CBO and NIPA, OFCE April 2018 forecasts.

[1] See the section on Budget policy: Crisis-free acceleration [“Politiques budgétaires : accélération sans crise”] in our [April 2017 forecast](#) for greater detail.

[2] See [here](#) for more on this.

[3] The growth gap expresses – as a % of potential GDP – the difference between observed GDP and potential GDP. Recall that potential GDP is not observed but estimated. The method of calculation used by the Congressional Budget Office (CBO) is explained [here](#).

The potential headache of measuring economies in public expenditure

By Raul Sampognaro

Since 2009, the French budget deficit has been cut by 3.3 GDP points, from 7.2 percent of GDP in 2009 to 3.9 points in 2014, even though the economic situation has been weighing heavily on the public purse. This improvement was due to the implementation of a tighter budget policy. [Between 2010 and 2013, most of the consolidation effort came from higher taxes](#), but since 2014 the effort has largely involved savings in public expenditure. In 2014, public expenditure excluding tax credits^[1] recorded its weakest growth since 1959, the year when INSEE began to publish the national accounts: in value, spending excluding tax credits increased by 0.9%, though only 0.3% in volume terms (deflated by the GDP deflator).

At first glance it may seem counter-intuitive to talk about savings on spending even though the latter has been rising constantly. This rise is, however, well below potential growth, which reflects a real long-term effort to reduce the ratio of spending to GDP. Indeed, the formula usually used to calculate the effort on spending depends on the hypothesis adopted on potential growth:

To understand why the extent of the effort on public expenditure is dependent on potential growth, one must understand the underlying concept of the sustainability of the debt. There is a consensus on the theoretical definition of the sustainability of the public debt: it is sustainable if the current stock of debt could be repaid by the anticipated future stream of the State's net revenues^[2]. While the concept is clear, its practical application is more difficult. In practice, fiscal policy is deemed sustainable when it makes it possible to stabilize the ratio of public debt to GDP at a level deemed consistent with maintaining refinancing by the market.

Thus, changes in spending that are in line with that goal should make it possible to stabilize the share of public expenditure to GDP over the long term. However, as public spending essentially responds to social needs that are independent of the economic situation (apart from certain social benefits such as unemployment insurance), stabilizing its share in GDP at any given time (which would imply it changes in line with GDP) is neither assured nor desirable. In order to deal with this, changes in the value of public expenditure are compared to the nominal growth rate of potential GDP^[3] (which depends on the potential growth rate and the annual change in the GDP deflator).

An increase in expenditure that is above (respectively below) the potential reflects a positive (negative) impulse, because in the long run it leads to an increase (decrease) in the

ratio of public spending to GDP. While the application of this concept may seem easy, potential growth is unobservable and uncertain because it is highly dependent on the assumptions made about demographic variables and future changes in productivity. In the 2016 Budget Bill (PLF), the government revised its potential growth assumptions for the years 2016 and 2017 upwards (to 1.5% instead of 1.3% as adopted at the time of the vote on the LPFP supplementary budget bill in December 2014).

This revision was justified on the basis of taking into account the structural reforms underway, in particular during the vote on the Macron Act. This was the second revision of potential since April 2014 when it was estimated at 1.6% (2014-2017 Stability Programme). The government is not the only one to repeatedly revise its assessments of potential growth. When the European Commission published its latest projections[\[4\]](#), it revised its assessment of potential growth even though its previous assessment had been issued only in May[\[5\]](#). It is not easy to see what new information could change its assessment now. These recurring revisions generally complicate the economic debate[\[6\]](#) and cloud discussion of the budget.

Hence using identical sets of hypotheses about the public finances, a measurement of savings on spending, and thus of the structural adjustment, would depend on the potential growth adopted (Table). Assuming a value for the growth in public spending (excluding tax credits) of +1.3% in 2016 and in 2017, the scale of the effort on spending was evaluated at 0.7 GDP point in October 2015 (using the hypotheses in the 2016 PLF) but 0.6 point in December 2014 (2014-2019 LPFP).

Table 1. Evaluation of the effort on public expenditure based on different hypotheses for potential growth

In %

	Potential growth			Effort on spending		
	2015	2016	2017	2015	2016	2017
2016 PLF, October 2015	1,1	1,5	1,5	-0,6	-0,7	-0,5
2014-2019 LPFP, December 2014	1,1	1,3	1,3	-0,6	-0,6	-0,4
2015 PLF, October 2014	1,1	1,3	1,3	-0,6	-0,6	-0,4
2014-2017 Stability Programme, April 2014	1,5	1,6	1,6	-0,8	-0,7	-0,5
2014 PLF, September 2013	1,5	1,6	1,6	-0,8	-0,7	-0,5
2012-2017 LPFP, January 2013	1,5	1,6	1,6	-0,8	-0,7	-0,5
November 2015 forecast	1,0	1,1	1,2	-0,5	-0,4	-0,3
May 2015 forecast	1,0	1,1	—	-0,5	-0,4	—
Ageing Working Group*, May 2015	1,1	1,1	—	-0,6	-0,4	—
Ageing Working Group**, May 2015	1,6	1,6	1,6	-0,8	-0,7	-0,5

* simple average of the potential growth of 2013 and of 2020 published in *The 2015 Ageing Report*.

** average of the 2013-2060 potential growth published in *The 2015 Ageing Report*.

Sources : PLF, LPFP, European Commission forecasts, *The 2015 Ageing Report*.

While the differences identified above may seem small, they can have significant consequences on the implementation of fiscal rules, which can lead the various players to act on their assumptions in order to change the effort shown [\[7\]](#). Even though this notion should guide the vision of the future trajectory of Europe's economies, the debate winds up being hijacked. Recurrent revisions in potential growth focus discussion on the more technical aspects, even though the method of estimating potential growth is uncertain by definition and there is not even a consensus among economists. Thus, the European Semester, which should set the framework for discussion and coordination between Member States in determining the economic policy that best suits the macroeconomic context, for France and for the euro zone as a whole, gets lost amidst technical discussions that are of no particular interest.

[\[1\]](#) Reimbursable tax credits – essentially the CICE and the CIR credits – are recognized in public expenditure on the basis of the 2010 national accounts. In order to remain

closely in line with economic concepts, public spending will be analyzed excluding tax credits, which will be considered as a component of taxation.

[2] This definition is accepted both by the academic literature (see for example, D'Erasmus P., Mendoza E. and Zhang J., 2015, "What is a Sustainable Public Debt?", *NBER WP*, no 21574, September 2015, and by international organizations (see IMF, 2012, "Assessing Sustainability").

[3] It can also be compared to an underlying trend in public expenditure which itself takes into account the changing needs to which spending responds.

[4] The European Commission expects France to grow by 1.1% in 2015, 1.4% in 2016 and 1.7% in 2017.

[5] The evaluation has changed to the second decimal.

[6] For this debate, see H. Sterdyniak, 2015, "Faut-il encore utiliser le concept de croissance potentielle?" [Should the concept of potential growth still be used?], *Revue de l'OFCE*, no. 142, October 2015.

[7] The revisions of potential growth may have an impact on the implementation of procedures. These revisions cannot give rise to penalties. At the sanctions stage, the European Commission's hypothesis on potential growth, made at the recommendation of the Council, is used in the discussion. However, it is likely that a difference of opinion on an unobservable variable could generate friction in the process, reducing the likelihood of sanctions and making the rules less credible.

Revising the budget in Croatia: yes, but ... for whom and why?

By [Sandrine Levasseur](#)

Under the [excessive deficit procedure that Croatia has been subject to since 28 January 2014](#), the country's government has been obliged to revise its projected budget for the forthcoming three years, which is the timeframe that has been set for putting its finances into "good order", with "good order" being understood to mean a public deficit that does not exceed 3% of GDP. This new budget is being fixed in adverse economic conditions, as the government's forecast of GDP growth for 2014 has been revised downward from 1.3% to a tiny 0.2%.

Paradoxically, the new budget could help prolong the recession in the country rather than help it recover, at least in 2014. This paradox is especially worth noting since this is also the opinion of those for whom the Croatian government is making this adjustment: first of all, the [rating agencies](#), and second, the international institutions (or at least [the IMF](#), as the European Commission has to keep quiet on the matter). In fact, a simple glance at the revised budget is enough to see that the fiscal adjustment being proposed by the Croatian government will not have an expansionary impact on GDP. For example, the budget provides for a hike in tax revenues, in particular through an increase in the rate of health insurance contributions from 13% to 15%. But this will also result in undermining the [international competitiveness of the country's businesses](#), which have already been hit hard.

The wages and bonuses of civil servants will fall (by about 6%) so as to give the public finances some breathing room. But

these cuts in civil servant salaries will not help perk up domestic demand, which has been anaemic due to the [adjustments consumers and businesses have made in their balance sheets](#). To take the latest example, to help bail out the state finances the profits of state enterprises will not be reinvested in the economy. However, the country is thereby depriving itself of a source of growth since, because of their weight in the economy, these enterprises account for a large [share of productive investment](#).

There is no doubt that Croatia's public finances need to be cleaned up. However, the horizon for the fiscal consolidation decided on by the Croatian government seems to us extremely "short-termist", as it doesn't call into question the existing model of growth or seek sources of sustainable growth. A few weeks ago, in an [OFCE note](#) we discussed the impact alternative fiscal adjustments would have on growth and the public finances. In the specific [case of Croatia](#), the government cannot avoid the need to consider doing the following: restructuring the productive apparatus (including through privatization and concessions); improving the system of tax collection; and, more broadly, implementing an anti-corruption policy to improve the country's "business climate". In the meantime, in large part due to the fiscal decisions being taken, 2014 is likely to wind up as the sixth year in a row Croatia has been in recession. The IMF forecasts, which anticipate that the recessionary impact of the fiscal consolidation will be greater than that projected by the Croatian government, [is expecting GDP to fall by about 0.5% to 1%](#) in 2014. In total, the decline in GDP since 2009 will therefore come to between 11.6% and 12.5%. It's not exactly the stuff of dreams....

Austerity in Europe: a change of course?

By Marion Cochard and Danielle Schweisguth

On 29 May, the European Commission sent the members of the European Union its new economic policy recommendations. In these recommendations, the Commission calls for postponing the date for achieving the public deficit goals of four euro zone countries (Spain, France, Netherlands and Portugal), leaving them more time to hit the 3% target. Italy is no longer in the excessive deficit procedure. Only Belgium is called on to intensify its efforts. Should this new roadmap be interpreted as a shift towards an easing of austerity policy in Europe? Can we expect a return to growth in the Old Continent?

These are not trivial matters. [An OFCE Note \(no. 29, 18 July 2013\)](#) attempts to answer this by simulating three scenarios for fiscal policy using the [iAGS model](#). It appears from this study that postponing the public deficit targets in the four euro zone countries does not reflect a real change of course for Europe's fiscal policy. The worst-case scenario, in which Spain and Portugal would have been subject to the same recipes as Greece, was, it is true, avoided. The Commission is implicitly agreeing to allow the automatic stabilizers to work when conditions deteriorate. However, for many countries, the recommendations with respect to budgetary efforts still go beyond what is required by the Treaties (an annual reduction in the structural deficit of 0.5 percent of GDP), with as a consequence an increase of 0.3 point in the unemployment rate in the euro zone between 2012 and 2017.

We believe, however, that a third way is possible. This would

involve adopting a “fiscally serious” position in 2014 that does not call into question the sustainability of the public debt. The strategy would be to maintain a constant tax burden and to allow public spending to keep pace with potential growth. This amounts to maintaining a neutral fiscal stimulus between 2014 and 2017. In this scenario, the public deficit of the euro zone would improve by 2.4 GDP points between 2012 and 2017 and the trajectory in the public debt would be reversed starting in 2014. By 2030, the public deficit would be in surplus (0.7%) and debt would be close to 60% of GDP. Above all, this scenario would lower the unemployment rate significantly by 2017. The European countries could perhaps learn from the wisdom of Jean de La Fontaine’s fable of the tortoise and the hare: *“Rien ne sert de courir, il faut partir à point”*, i.e. Slow and steady wins the race.

In the Netherlands, change is for now!

By [Christophe Blot](#)

While France has just reaffirmed that it will meet its commitment to reduce its budget deficit to below 3% by 2014 (see [Eric Heyer](#)), the Netherlands has announced that it is abandoning this goal on the grounds that additional austerity measures could jeopardize growth. The country plunged into recession in 2012 (-1%), and GDP will fall again in 2013 (see [the analysis of the CPB](#), the Netherlands Bureau for Economic Policy Analysis). In these circumstances, the social situation has deteriorated rapidly, with a 2 percentage point rise in unemployment in five quarters. In the first quarter of 2013, 7.8% of the workforce was out of work. Beyond the implications

for the Netherlands itself, could this rejection of austerity (finally) signal a shift in Europe's strategy of fiscal consolidation?

Up to now, the coalition government elected in September 2012 and led by the Liberal Mark Rutte had followed the general strategy of consolidation, with expectations of rapidly bringing the deficit below 3%. However, the austerity measures already being implemented together with an adjustment in the housing market and the general decline in activity throughout the euro zone led the Netherlands into a new recession in 2012 and put off the prospects of meeting the budget target in 2013. In view of the European Commission's projections for growth and for the budget deficit in 2013, it does however seem that the Dutch government would have been able to achieve a deficit of 3% in 2014, but like France, at the cost of taking additional measures.

The budget deficit is expected by the Commission to come to 3.6% in 2013. The CPB expects an even slightly lower deficit (3.3%), using growth forecasts similar to those of the Commission. In these conditions, the fiscal effort required to reach the 3% target in 2014 would amount to between 3.5 and 7 billion euros. In comparison, for France this would require the approval of additional austerity measures for 2014 amounting to 1.4 GDP points, *i.e.* just under 30 billion euros (see [France: holding to the required course](#)).

However, under pressure from the social partners, the Dutch government ultimately abandoned the plan announced on March 1 that provided for savings of 4.3 billion euros, which mainly consisted of a wage freeze in the public sector, a freeze in the income tax scale and the stabilization of public spending in real terms. Putting austerity on hold like this should give a small boost to the economy without calling into question fiscal sustainability, as the improved prospects for growth should reduce the cyclical component of the budget deficit.

While the 3% target will of course not be met, it is not at all clear that the markets will make much out of this infringement of the rules. In fact, the difference in interest rates vis-à-vis the German rate has stabilized since it was announced that the plan had been abandoned, whereas the difference had tended to increase in the previous weeks (see figure).



While this decision should not upset the economic and financial stability of the Netherlands or the euro zone, it does nevertheless send a strong anti-austerity signal from a country that had hitherto favored fiscal consolidation. It is therefore one more voice that is challenging the effectiveness of this strategy and emphasizing the economic and social risks associated with it ([see here](#) for an overview of the case against austerity and the 2013 [iAGS report](#) for more specific points concerning an alternative strategy for Europe). It is also a decision that should give France inspiration. Credibility is not necessarily gained by sacrificing one objective (growth and employment) for another (the budget deficit). It is still necessary to await the response of the European Commission in that the Netherlands, like most countries in the euro zone, is subject to an excessive deficit procedure. If the decision of the Netherlands is not challenged, then this will represent a significant shift in European macroeconomic strategy.

And what if the austerity budget has succeeded better in France than elsewhere? [1]

By [Mathieu Plane](#)

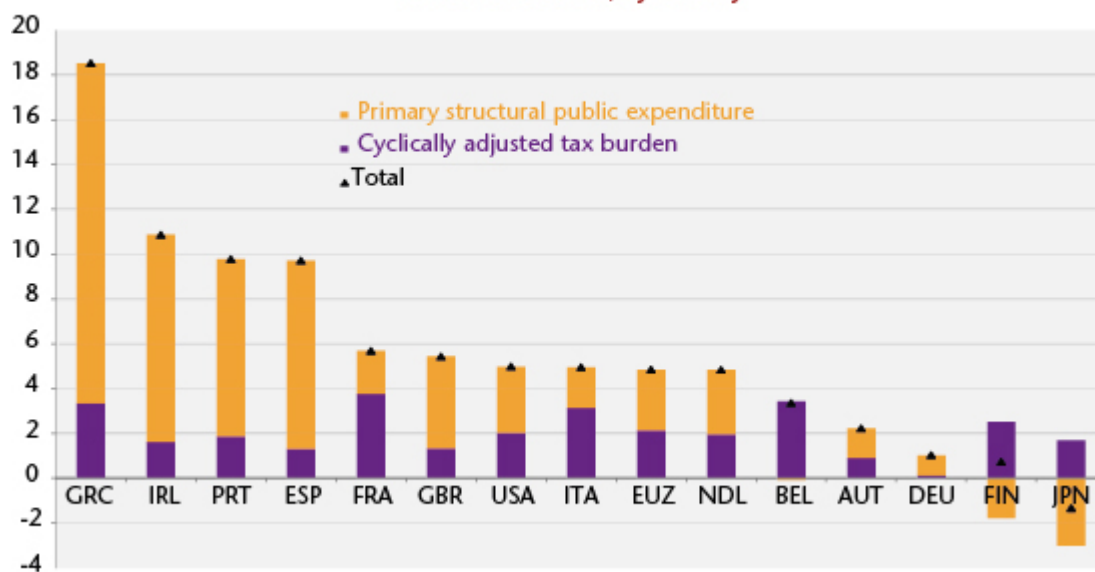
Faced with a rapid and explosive deterioration in their public accounts, the industrialized countries, particularly in Europe, have implemented large-scale austerity policies, some as early as 2010, in order to quickly reduce their deficits. In a situation like this, several questions about France's fiscal policy need to be examined:

- First, has France made a greater or lesser fiscal effort than other OECD countries to deal with its public accounts?
- Second, is there a singularity in the fiscal austerity policy implemented by France and has it had more or less effect on growth and the level of unemployment?

With the notable exception of Japan, between 2010 and 2013 all the major OECD countries implemented policies to reduce their primary structural deficits [2]. According to the [latest OECD figures](#), these policies represented a fiscal effort of about 5 percentage points of GDP over three years on average in the euro zone, the United States and the United Kingdom. In contrast, the differences within the euro zone itself were very large: they range from only 0.7 percentage points in Finland to more than 18 points in Greece. Among the major industrialized countries of the OECD, France is, after Spain, the country that has made the greatest fiscal effort since 2010 from a structural viewpoint (5.7 percentage points of GDP over three years). In the post-World War 2 era, France has never experienced such a brutal and sustained adjustment in its public accounts. For the record, the budget effort that took place in the previous period of sharp fiscal

consolidation from 1994 to 1997 was twice as small (a cumulative negative fiscal impulse of 3.3 GDP points). Between 2010 and 2013, the cyclically adjusted tax burden increased in France by 3.8 GDP points, and the structural effort on public spending represented a gain of 1.9 GDP points over four years (Figure 1). Among the OECD countries, it was France that made the greatest cyclically adjusted increase in the tax burden in the period 2010-2013. Finally, from 2010 to 2013, the structural effort to reduce the public deficit broke down as follows: two-thirds involved an increase in the tax burden and one-third came from public spending. This breakdown is different from that observed on average in the euro zone, where the fiscal effort over the period 2010-13 involved a nearly 60% reduction in public expenditure, rising to over 80% in Spain, Portugal, Greece and Ireland. In contrast, in Belgium, the entirety of the fiscal effort came from a higher tax burden. And in the case of Finland, primary structural public spending in points of potential GDP rose over the period 2010-2013, which was more than offset by the increase in the tax burden.

Figure 1. Contribution of each component to the change in the primary structural balance from 2010 to 2013, by country

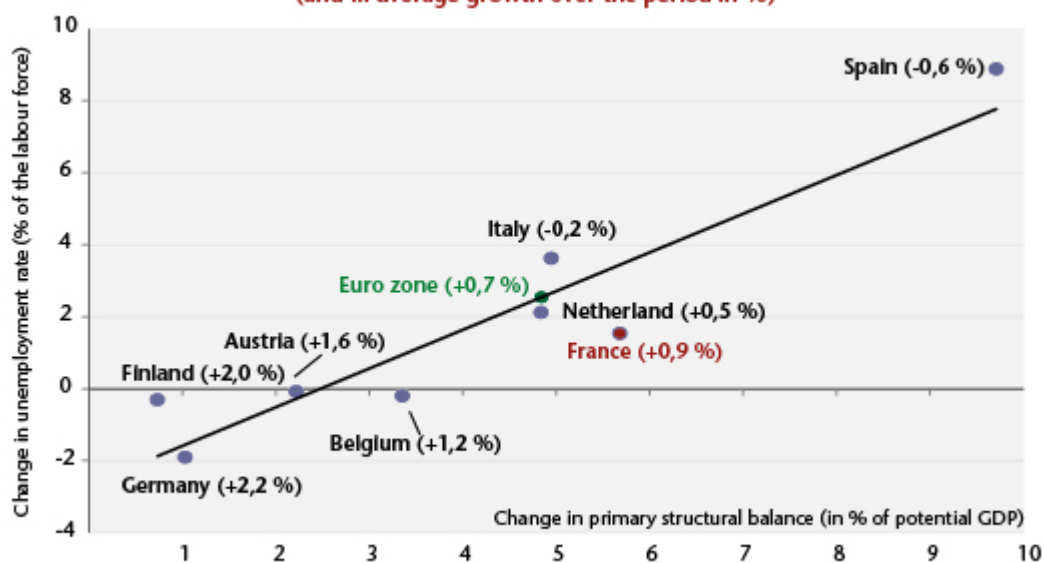


Sources: OECD, OFCE calculations.

While France's substantial budgetary efforts have undeniably had a negative impact on economic activity and employment, it

is nevertheless true that the budget decisions of the various governments since 2010 appear to have affected growth and the labour market relatively less than in most other countries in the euro zone. Within the euro zone-11, from 2010 to 2013 only four countries – Germany, Finland, Austria and Belgium – experienced average growth of over 1% per year, with unemployment rates that not only did not increase, but occasionally even fell. However, these are also the four countries that made the smallest reductions in their structural deficits over this period. France, on the other hand, is among the countries that made the greatest structural effort since 2010, and it has simultaneously managed to contain the rise in unemployment to some extent. Indeed, compared with the Netherlands, Italy and the euro zone average, France's fiscal policy was more restrictive by about 1 GDP point from 2010 to 2013, yet the unemployment rate increased by 40% less than in the Netherlands, 60% less than the euro zone average and more than two times less than in Italy. Likewise, growth in France was higher on average over this period: 0.9% per year, against 0.5% in the Netherlands, 0.7% in the euro zone and -0.2% in Italy.

Figure 2. Change between 2010 and 2013 in the primary structural balance and the unemployment rate (and in average growth over the period in %)



Sources: OECD Economic Outlook, November 2012; OFCE calculations.

Why has the French fiscal contraction had less impact on growth and employment than in most other countries? Beyond the

economic fundamentals, some evidence suggests that the budget decisions of the successive governments since 2010 may have led to fiscal multipliers that are lower than in the other countries. After Finland and Belgium, France is the country where public spending played the smallest role in reducing the structural deficit. As illustrated by recent studies, in particular the IMF study and the article signed by economists from the central banks in Europe and the U.S., the European Commission, the OECD and the IMF, targeting fiscal adjustment through raising the tax burden rather than cutting public spending has given France smaller short-term fiscal multipliers than those observed in countries that have made □ the opposite choice (Greece, Portugal, Ireland and Spain). In the case of France, nearly 50% of the fiscal adjustment was achieved by an increase in the direct taxation of household and business income (Table 1). And as has also been the case for the United States, Belgium and Austria, which achieved between 50% and 75% of their fiscal adjustment by increasing direct taxation, it seems that these countries have also done best at maintaining their growth in the face of the budget cuts. Conversely, the ones that have used this lever the least in their fiscal adjustments are the southern European countries and the Netherlands.

Table. Contribution of each component to the change in the primary structural balance between 2010 and 2013, by country

In % of potential GDP	GRC	IRL	PRT	ESP	FRA	GBR	USA	ITA	EUZ	NLD	BEL	AUT	DEU	FIN	JPN
Primary structural balance (PSB)															
(= a + b)	18,5	10,9	9,8	9,7	5,7	5,4	5,0	4,9	4,8	4,8	3,4	2,2	1,0	0,7	-1,3
Cyclically adjusted tax burden (a)	3,3	1,6	1,9	1,3	3,8	1,3	2,0	3,1	2,1	2,0	3,4	0,9	0,1	2,5	1,7
o/w increase in direct taxes on household and business income	1,5	3,2	1,9	1,2	2,7	0,0	2,4	1,2		0,8	1,7	1,7	0,1	0,6	0,9
Primary public spending (b)	15,2	9,2	7,9	8,4	1,9	4,1	3,0	1,8	2,7	2,9	-0,1	1,3	0,9	-1,8	-3,0
Contribution of primary public spending to the change in the PSB	82	85	81	87	34	76	59	36	56	60	-2	59	89	-242	225

Sources: OECD Economic Outlook, November 2012; OFCE calculations.

[\[1\]](#) This post makes use of certain parts of the article

published in [*Alternatives Economiques*, M. Plane, “L’austérité peut-elle réussir en France ?”, Special issue no. 96, 2nd quarter 2013.](#)

[2] The primary structural deficit measures the structural fiscal effort made by general government (*les administrations publiques*). It corresponds to the public balance, excluding interest charges, that would be generated by the government if the GDP of the economy were at its potential level. This measure is used to adjust the public balance for cyclical effects.

Why France is right to abandon the 3% public déficit target by 2013

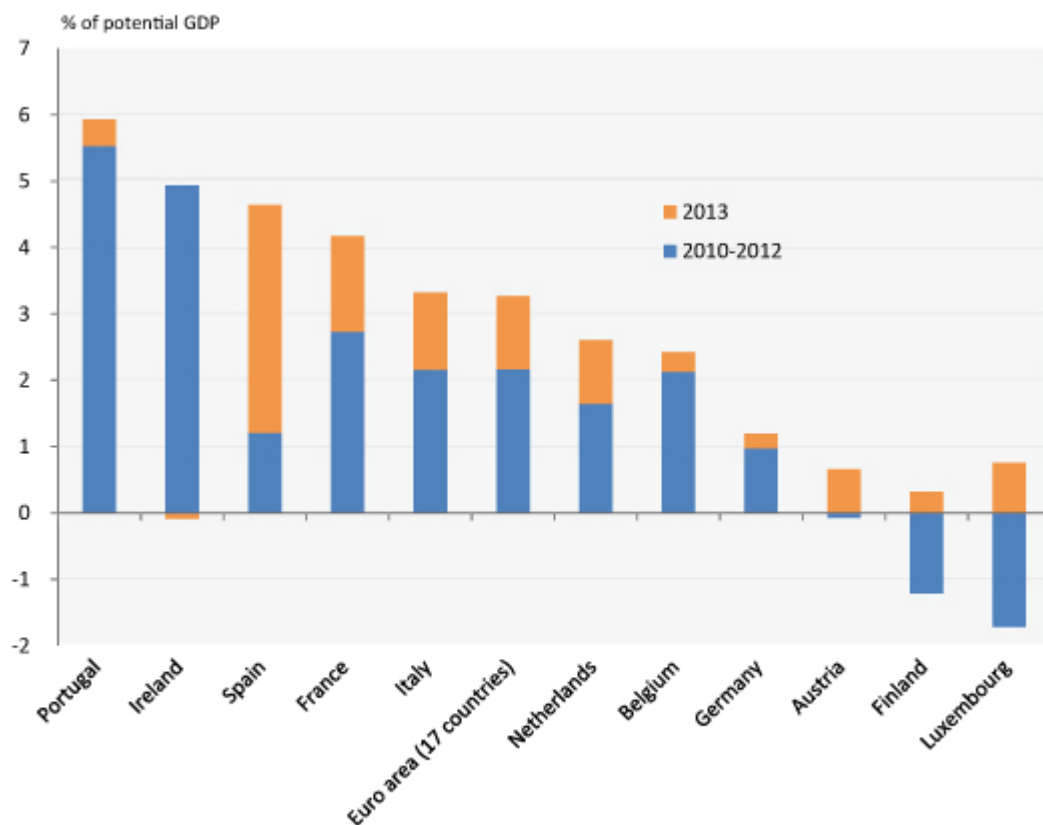
By [Mathieu Plane](#)

Given the statements by the Minister of Economy and Finance, the government seems to have reached a decision to abandon the goal of a deficit of 3% of GDP by 2013. In addition to the change of tack in the policy announced up to now, which was to bring the deficit down to 3% by 2013 “whatever the cost”, we can legitimately conclude that France is right to abandon this goal, and we offer several arguments for this. While in this post we do not review [the economic consequences of the fiscal policy being undertaken in France and the euro zone](#), which has been dictated by nominal targets for the deficit that do not

take into account the way it breaks down structurally / cyclically and that have a dangerously pro-cyclical character, we nevertheless present several arguments that the European Commission may find of value:

1 – According to the latest figures from the European Commission on 22 February 2013^[1], of the euro zone countries making the greatest fiscal adjustment in 2013 from a structural viewpoint, France, with 1.4 GDP points, comes behind only Spain (3.4) and Greece (2.6). For the 2010-2013 period, the reduction in France's structural deficit represents 4.2 GDP points, which makes France the euro zone country which, alongside Spain (4.6 GDP points), has carried out the largest budget cutbacks of the major countries in the zone, ahead of Italy (3.3 GDP points), the Netherlands (2.6) and of course Germany (1.2) (Figure 1).

Figure 1. Change in the structural deficit of the euro zone countries*



* For reasons of scale, we have not put Greece in the figure. Over the 2010-2013 period, Greece's structural fiscal adjustment came to 16.9 GDP points, including 2.6 in 2013.

Sources: European Commission, OFCE calculations.

2 – In 2007, before the crisis, according to the European Commission France had a structural public deficit of -4.4 GDP points, compared with an average of -2.1 for the euro zone and -0.9 for Germany. In 2013, this came to -1.9 GDP points in France, -1.3 for the euro zone, and +0.4 for Germany, which represents an improvement of the structural deficit of 2.5 GDP points for France since the start of the crisis, *i.e.* three times the average for the euro zone and twice that for Germany (Table 1). Leaving aside public investment, France's structural public deficit in 2013 was positive and higher than the euro zone average (1.2 GDP point in France, versus 0.8 for the euro zone average and 1.9 for Germany). Note that France is spending 3.1 GDP points on public investment in 2013 (0.2 GDP point less than in 2007), against a euro zone average of only 2 points (0.6 point less than in 2007) and 1.5 in Germany (equivalent to 2007). However, public investment, which has a positive impact on potential growth, and which also increases public assets, while not changing the public administration's financial situation, can reasonably be excluded from the calculation of the structural public deficit.

Table. Public deficit and structural deficit with and without public investment

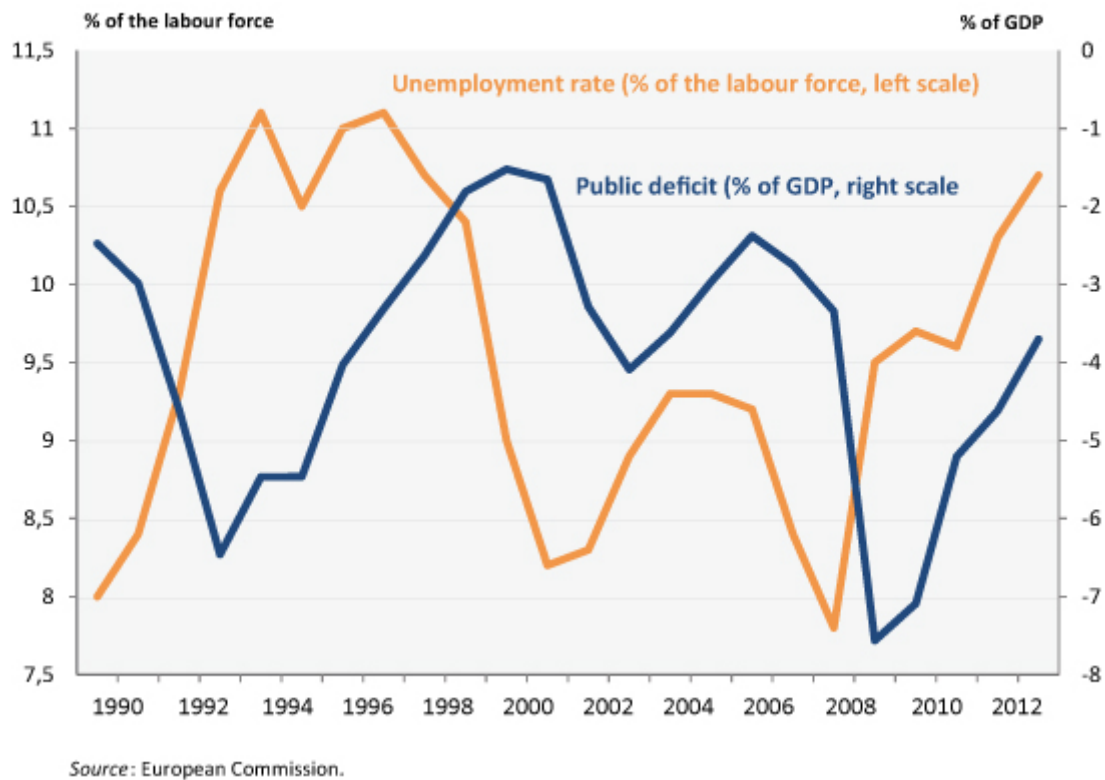
In GDP points	Public balance				Structural public balance				SPB w/o public investment			
	FRA	DEU	EZ	FRA-EZ diff.	FRA	DEU	ZE	FRA-EZ diff.	FRA	DEU	EZ	FRA-EZ diff.
2007	-2.8	0.2	-0.7	-2.1	-4.4	-0.9	-2.1	-2.3	-1.1	0.6	0.5	-1.6
2013	-3.7	-0.2	-2.8	-0.9	-1.9	0.4	-1.3	-0.6	1.2	1.9	0.8	0.4
Change 2007-2013	-0.9	-0.4	-2.1	1.2	2.5	1.3	0.8	1.6	2.3	1.3	0.3	2.1

Sources : European Commission, OFCE calculations.

3 – In 2013, the public deficit, even at 3.7% of GDP according to the European Commission, is once again at a level close to that of 2008, similar to that of 2005, and below that of 2004 and of the entire 1992-1996 period. The public deficit figure expected for 2013 corresponds to the average over the past

thirty years, and thus no longer seems so exceptional, which is easing the pressure that France could experience on the financial markets. In contrast, according to the European Commission the unemployment rate in France in 2013 will reach 10.7% of the workforce, which is very close to its historic peak in 1997 (Figure 2). With an unemployment rate in 2013 that is 1.3 percentage points higher than the average over the last thirty years, an exceptional situation now characterizes the labour market more than it does the government deficit. While new austerity measures would help to reduce the deficit, however painfully, due to the [high value of the fiscal multiplier in the short term](#) they will lead on the other hand to going well beyond our historic unemployment peak. Indeed, as we showed in our [latest forecast in October 2012](#), if France really tries to meet its budget commitment for 2013 “whatever the cost”, this will require a new fiscal tightening of over 20 billion euros, in addition to the [36 billion euros already planned](#). This would lead to a recession, with GDP down -1.2% and 360,000 job losses (instead of expected growth of 0% and the loss of about 160,000 jobs), with the unemployment rate reaching 11.7% of the labour force by late 2013.

Figure 2. Public deficit and unemployment rate



To restore its public accounts since 2010, France has undertaken a historic fiscal effort, well beyond the average of its European partners, which has cost it in terms of growth and employment. Adding another layer of austerity in 2013 to the already historic build-up of austerity would lead us this year straight into a recession and an unprecedented worsening in the labour market. If there is a choice, are a few tenths of a point in the public deficit worth such a sacrifice? Nothing is less certain. It is thus essential to put off the goal of reducing the deficit to 3% of GDP to at least 2014.

[1] We have a different evaluation of the level of the structural deficit. For example, for 2013 we evaluate the improvement in France's structural public deficit at 1.8 GDP points, but in order not to prejudice the analysis we are

using the figures provided by the Commission.

Spain: a lose-lose strategy

by Danielle Schweisguth

At a time when the [IMF](#) has publicly recognized that it underestimated the negative impact of fiscal adjustment on Europe's economic growth, Spain is preparing to publish its public deficit figure for 2012. The initial estimate should be around 8% of GDP, but this could be revised upwards, as was the case in 2011 – while the target negotiated with the European Commission is 6.3%. With social distress at a peak, only a sustainable return to growth would allow Spain to solve its budget problems through higher tax revenue. But the austerity being imposed by Europe is delaying the return of economic growth. And the level of Spain's fiscal multiplier, which by our estimates is between 1.3 and 1.8, is rendering the policy of fiscal restraint ineffective, since it is not significantly reducing the deficit and is keeping the country in recession.

At a time when the [IMF](#) has publicly recognized that it underestimated the negative impact of fiscal adjustment on Europe's economic growth – the famous fiscal multiplier – Spain is preparing to publish its public deficit for 2012. The initial estimate should be around 8% of GDP, but this could be revised upwards as was the case in 2011. If we exclude the financial support for the banking sector, which is not taken into account in the excessive deficit procedure, the deficit

then falls to 7% of GDP. This figure is still higher than the official target of 6.3% that was the subject of bitter negotiations with the European Commission. Recall that until September 2011, the initial target deficit for 2012 was 4.4% of GDP. It was only after the unpleasant surprise of the publication of the 8.5% deficit for 2011 (which was later revised to 9.4%) – which was well above the official 2011 target of 6% of GDP – that the newly elected government of Mariano Rajoy asked the European Commission for an initial relaxation of conditions. The target deficit was then set by Brussels at 5.3% of GDP for 2012. In July 2012, pressure on Spain's sovereign rate – which approached 7% – then led the government to negotiate with the Commission to put off the 3% target to 2014 and to set a deficit target of 6.3% of GDP in 2012.

Tableau. Growth, fiscal impulse and the public deficit in Spain

	2007	2008	2009	2010	2011	2012
GDP growth (%)	3,5	0,9	-3,7	-0,3	0,4	-1,4
Fiscal impulse (% of GDP)	0,6	1,0	1,3	-2,2	-0,9	-3,3
Public deficit* (% of GDP)	1,9	-4,5	-11,2	-9,7	-9,4	-8,0

* The public deficit includes the financial support given to the banking sector.

Sources : Ministerio de Hacienda y Administraciones Publicas, OFCE forecast for 2012.

But the strategy of trying to reduce the deficit by 2.6 GDP points while in a cyclical downturn proved to be ineffective and even counter-productive. Furthermore, the result has not been worth the effort involved, even though the European authorities have praised it repeatedly. A succession of three consecutive years of austerity plans of historic proportions (2010, 2011 and 2012) has led to only a very small improvement in the budget balance (Table). The deficit was reduced by 3.2 percentage points in three years, while two years of crisis were enough to expand it by 13.3 points (from 2007 to 2009). The fiscal impulse was -2.2 percentage points of GDP in 2010, -0.9 point in 2011 and -3.3 points in 2012, or a total of 6.4

GDP points of fiscal effort (68 billion euros). Yet the crisis has precipitated the collapse of the real estate market and greatly weakened the banking system. Since then, the country has plunged into a deep recession: GDP has fallen by 5.7% since the first quarter of 2008, which puts it 12% below its potential level (assuming potential growth of 1.5% per year), with 26% of the workforce currently unemployed, in particular 56% of the young people.

The deterioration of Spain's economic situation has hit tax revenue very hard. Between 2007 and 2011, the country's tax revenues have fallen further than in any other country in the euro zone. Revenue declined from 38% of GDP in 2007 to 32.4% in 2011, despite a hike in VAT (2 points in 2010 and 3 points in 2012) and an increase in income tax rates and property taxes in 2011. The successive tax increases only slightly alleviated the depressive effect of the collapse of the tax base. VAT revenues recorded a sharp drop of 41% in nominal terms between 2007 and 2012, as did the tax on income and wealth (45%). In comparison, the decrease in tax revenue in the euro zone was much more modest: from 41.2% of GDP in 2007 to 40.8% in 2011. Finally, rising unemployment has undermined the accounts of the social security system, which will experience a deficit of 1 percentage point of GDP in 2012 for the first time in its history.

To compensate for the fall in tax revenue, the Spanish government had to take drastic measures to restrict spending to try to meet its commitments, including a 5% reduction in the salaries of civil servants and the elimination of their Christmas bonus; a hiring freeze in the public sector and increasing the work week from 35 to 37.5 hours (without extra pay); raising the retirement age from 65 to 67, along with a pension freeze (2010); a reduction of unemployment benefits for those who are unemployed more than seven months; and lowering severance pay from 45 days per year worked to 33 days (20 if the company is in the red). Even though household

income has stagnated or declined, Spanish families have experienced a significant increase in the cost of living: a 5-point increase in VAT, higher electricity rates (28% in two years), higher taxes on tobacco and lower reimbursement rates for medicines (retirees pay 10% of the price and the employed 40% to 60%, depending on their income).

The social situation in Spain is very worrying. Poverty has increased (from 23% of the population in 2007 to 27% in 2011, according to Eurostat); households failing to pay their bills are being evicted from their homes; long-term unemployment has exploded (9% of the labour force); unemployed youth are a lost generation, and the best educated are emigrating. The VAT increase in September has forced households to tighten their budgets: spending on food declined in September and October 2012, respectively, by 2.3% and 1.8% yoy. Moreover, the Spanish health system is suffering from budget cuts (10% in 2012), which led to the closure of night-time emergency services in dozens of municipalities and to longer waiting lists for surgery (from 50,000 people in 2009 to 80,000 in 2012), with an average waiting time of nearly five months.

Social distress is thus at a peak. The movement of the *indignados* led millions of Spaniards to take to the streets in 2012, in protests that were often violently suppressed by riot police. The region of Catalonia, the richest in Spain but also the most indebted, is threatening to secede, to the consternation of the Spanish government. On 24 January, the Catalan government passed a motion on the region's sovereignty, the first step in a process of self-determination that could lead to a referendum in 2014.

Only a lasting return to growth would enable Spain to solve its budget problems through higher tax revenue. But the tightening of financing conditions on Spain's sovereign debt since the summer of 2012 has forced the government to strengthen its austerity policy, which is delaying the return to economic growth. Furthermore, the European Commission has

agreed to provide financial assistance to Spain only if it renounces its sovereignty in budget matters, at least partially, which the government of Mariano Rajoy is still reluctant to accept. The initiative of the European Commission on the exclusion of capital expenditures from calculations of the public deficit for countries close to a balanced budget, the details of which will be published in the spring, is a step in the right direction ([El Pais](#)). But this rule would apply only to the seven countries where the fiscal deficit is below 3% of GDP (Germany, Luxembourg, Sweden, Finland, Estonia, Bulgaria and Malta), which leaves out the countries facing the most difficult economic situations. Greater awareness of the social dramas that underlie these poor economic performances should lead to greater respect for the fundamental rights of Europe's citizens. Moreover, in [the 2013 iAGS report](#) the OFCE showed that a restrained austerity policy (budget restrictions limited to 0.5 percent of GDP each year) is more effective from the viewpoint of both growth and deficit reduction in countries like Spain where the fiscal multipliers are very high (between 1.3 and 1.8, according to our estimates).

Could France have a different fiscal policy?

By [Jérôme Creel](#)

Shouldn't the economic crisis that is gripping the euro zone, including France, lead to calling into question the approach being taken by fiscal policy? In light of the unprecedented [broad consensus](#) among economists about the impact of fiscal policy on the real economy, it is clear that the austerity

measures being adopted by France are a mistake. Moreover, invoking European constraints is not a good enough argument to exclude a much more gradual process of putting the public purse in order (also see the [iAGS project](#)).

There is no need to go beyond what European legislation requires, and doing so can be especially harmful if in fact the additional budgetary efforts generate less growth and, ultimately, further deterioration in the public finances due to higher social spending and lower tax revenue. What do the existing European treaties actually demand? In the case of a government deficit that exceeds 3% of GDP, the minimum effort required for fiscal adjustment consists of reducing the cyclically adjusted deficit, *i.e.* the structural deficit, by at least 0.5% of GDP per year. Furthermore, the time period for reducing the debt to 60% of GDP is 20 years. Finally, exceptional circumstances now include an “unusual event” that could justify deviating from the current standards for the deficit.

Based on these exceptional circumstances and on the rule requiring an annual improvement of at least 0.5% of GDP in the structural deficit, it can be shown that the French government has fiscal maneuvering room in 2012 and 2013, while still complying with European fiscal rules.

Table 1 lists the sequence of public deficits and of GDP growth from 2011 to 2013 according to two forecasts produced by the European Commission in the Spring and then the Autumn of 2012. According to the Spring forecast, the French structural deficit was supposed to decrease by 1.2% of GDP between 2011 and 2013, on average slightly above what is required by the Commission. In fact, the improvement from 2011 to 2012 exceeded 0.5% of GDP, while it fell below that from 2012 to 2013.

What about the Autumn 2012 forecast? The expected improvement in France’s structural deficit was now expected to be 1.1% of

GDP between 2011 and 2012 and then 1.4% of GDP between 2012 and 2013, taking into account [the government's commitment to reduce public spending and raise taxes](#). These projected improvements in the structural deficit are two and three times greater than what European fiscal rules require, which is a lot! For the year 2013, this amounts to almost 20 billion euros that need not be levied on French households and businesses. Abandoning this levy does not mean abandoning fiscal austerity, but rather *spreading it out over time*.

Furthermore, the European Commission now expects a slowdown in the French economy in 2013. Unless one argues that the French government is responsible for this slowdown – and while this might indeed be the case in light of the austerity budget the government is imposing on the French economy, it is far from clear that the European Commission would want to employ such an argument, given its role in championing austerity! – this deterioration in the country's growth prospects could fall within the category of an “unusual event,” thus giving France an opening to invoke exceptional circumstances in order to *stagger* and *extend* its fiscal adjustment efforts.

Instead of awaiting the miraculous effects of structural reform – a potentially lengthy and uncertain process – all that is really needed is to apply the regulations in force, without imposing an overly restrictive reading of what they contain, so as to limit the reduction in growth being caused by austerity and avoid a new period of rising unemployment. According to the conclusions of the [iAGS report](#), staggering the fiscal austerity measures in France would lead to adding 0.7 GDP point to growth every year from 2013 to 2017.

The “unusual event” constituted by yet another year of very low growth in 2013 for France also opens the possibility of suspending the austerity policies, at least temporarily. Once again according to the findings of the iAGS report, the French government should put off till 2016 its policy of

consolidating the public finances. The gain in terms of growth would be 0.9 percentage point per year between 2013 and 2017. Provided that this policy is actually conducted carefully and not postponed indefinitely, it would enable France to reduce its public debt to GDP ratio in compliance with existing EU treaties.

Forecast for the French economy

		2011	2012	2013
Public deficit (% of GDP)	Spring 2012	5.2	4.5	4.2
	Autumn 2012	5,2	4.5	3.5
Structural deficit (% of GDP)	Spring 2012	4.1	3.2	2.9
	Autumn 2012	4.5	3.4	2.0
PIB (%)	Spring 2012	1.7	0.5	1.3
	Autumn 2012	1.7	0.2	0.4

Source: European Commission forecasts.