# 2013: what impact will the (national) fiscal measures have on growth?

By [Mathieu Plane](#)

*This text supplements the* [October 2012 forecasts for the French economy](#)

After having detailed the multiplier effects expected for the different fiscal policy instruments, the average domestic fiscal multiplier associated with the austerity measures being implemented in France in 2013 will be 0.9. This policy will cut GDP by 1.7% in one year alone. After a cumulative fiscal effort of 66 billion euros in 2011 and 2012, the structural saving expected for 2013 represents about 36 billion euros (1.8 GDP points) if we include both the measures in the 2013 budget bill (*Projet de loi de finances* – PLF) and the various measures adopted previously (Table). The fiscal shock resulting from the PLF for 2013 comes to 28 billion euros, of which 20 billion is solely on tax and social security contributions (*prélèvements obligatoires* – PO). Of the remaining 8 billion, an increase of nearly 5 billion euros in tax and social security contributions is from the second supplementary budget (*Loi de finances rectificative* – LFR) for the summer of 2012, the rest being mainly due to the first LFR for 2012 and to the hike in contributions resulting from the revision of the pension reform in summer 2012.

In total, the fiscal effort in 2013 can be broken down between tax and social contributions of about 28 billion euros (1.4 GDP points) and structural savings on primary public expenditure of 8 billion (0.4 GDP point). The burden of higher taxes and social contributions breaks down to nearly 16 billion euros for households and more than 12 billion for

business. This breakdown does not take into account the competitiveness measures announced on 6 November by the Prime Minister. The tax credits for competitiveness and employment (CICE) will not have any fiscal impact in 2013, with the exception of the possible establishment in 2013 of an advance on their future tax credits for some companies short of cash.

Based on the variants in the fiscal multiplier, made with e-mod.fr according to the economy's position in the cycle, for the main taxes and social security contributions as well as for the key components of public expenditure [1] and based on the different evaluations we were able to carry out, particularly in the context of the assessment of the Five-year economic programme, we applied a specific fiscal multiplier to each measure for 2013 (Table). The short-term multipliers take into account only the direct effects of the measures on domestic activity, regardless of the fiscal policies of our trading partners, which amplify the impact of national policy. It is also assumed that monetary policy remains unchanged. The long-term multiplier values differ from the short-term ones, being generally lower unless a long-term negative output gap is maintained.

Of the 16 billion euro increase in tax and social security contributions on households in 2013, the discretionary increase in personal income tax (IR) will be 6.4 billion, including 3.2 billion from the 2013 Budget Act (*Loi de finances*) – against 4 billion in the PLF, as the proposal to tax capital gains on securities at the income tax scale will be largely amended, and the yield from the measure could decrease by about 0.8 billion, with the shortfall being able to be offset by the extension of the exceptional 5% contribution from the IS tax on large corporations), and with the rest coming from the supplemental LFR for 2012 (including 1.7 billion solely from the de-indexation of the personal income tax schedule). While the increase in personal income tax from the 2013 PLF is targeted at high earners, the amount

this will contribute (3.2 billion) represents only 11% of the increase in tax and social security contributions (20% if we limit ourselves to households) in 2013, and less than 9% of the total fiscal effort. According to our calculations, the average fiscal multiplier associated with the different measures that increase personal income tax will be 0.7 in 2013.

The increase in taxes and social contributions from households will come mainly from the increase in payroll taxes and social security contributions (8.7 billion euros) set out in the Social Security budget act (PLF) for 2013 (2.9 billion) and the measures in the supplemental LFR for 2013 (5.3 billion, which includes changes to the tax exemption on overtime, a limitation on tax breaks and employee savings, a higher CSG wealth tax on income from capital, etc.) and pension reform, with an increase in the contribution rate (0.5 billion). The average fiscal multiplier related to these measures is 0.9. Finally, the reform of inheritance tax will raise a further 1.1 billion in tax and social contributions. On the other hand, the revenue from the ISF wealth tax will be 1.3 billion lower than in 2012. Indeed, the yield from the one-off wealth tax contribution set up under the supplemental LFR for 2012 will be greater than from the one set up under the new reform in 2013. The fiscal multiplier for these two measures is 0.3.

In total, according to our calculations, the increase in levies on households in 2013 will on average have a multiplier of 0.8 and will amputate growth by 0.6 GDP point.

For business, the measures adopted mainly involve an increase in the corporate income tax as provided in the budget bill (PLF) for 2013 (8 billion euros, of which 4 billion is related to the reform of the deductibility of financial expenses). The average multiplier for the increase in the corporate income tax (IS) is estimated at 0.7 in 2013. 2.3 billion euros will come from a rise in social security contributions and payroll taxes with a fiscal multiplier of unity. Finally, other

measures such as the sectoral measures on the taxation of insurance or the exceptional contribution of the oil industry will increase the tax burden on business by 1.9 billion in 2013, with an average fiscal multiplier estimated at 0.5.

In our assessment, the increase in taxes and social contributions from companies will on average have a multiplier of 0.8 and will reduce GDP by 0.5 GDP point in 2013.

In addition, the short-term fiscal multiplier associated with public expenditure in a low phase of the cycle is, in our model, 1.3, so it is higher than that associated with tax and social contributions. This result is consistent with the most recent empirical literature (for details, see the box, "Fiscal multipliers: size matters!" The estimated loss of activity resulting from tightening up on public expenditure will come to 0.5 GDP point in 2013.

In total, the average domestic fiscal multiplier associated with the austerity policy being implemented in France in 2013 will be 0.9, and this policy will reduce GDP by 1.7%. This result is in the lower range of the latest work of the IMF; using recent data on 28 countries, it has estimated the actual multipliers at between 0.9 and 1.7 since the beginning of the Great Recession.

**Main measures affecting the structural public deficit in 2013**

| | Measures (in bn) | Fiscal multiplier estimated in the short term | Impact on GDP (%) |
|---|---|---|---|
| **Households** | **15.7** | *0.8* | **-0.6** |
| **Income tax** | 6.4 | *0.7* | -0.2 |
| PLF 2013 (taxation of capital income at IR tax rate, new brackets, etc.)* | 3.2 | *0.6* | -0.1 |
| LFR II 2012 (reversal of tax exemption of overtime) | 0.5 | *0.4* | 0.0 |
| LFR I 2012 (de-indexation of IR brackets, suppression tax breaks and Scellier scheme, etc.) | 2.7 | *0.8* | -0.1 |
| **ISF wealth tax** | **-1.3** | *0.3* | **0.0** |
| PPLF 2013 (reform of ISF wealth tax) | 1.0 | *0.3* | 0.0 |
| LFR II 2012 (repercussions from one-off 2012 contribution) | -2.3 | *0.3* | 0.0 |
| **Inheritance tax** | **1.1** | *0.3* | **0.0** |
| LFR II 2012 (reversal of breaks on inheritance tax) | 1.1 | *0.3* | 0.0 |
| **Social contributions and payroll tax** | **8.7** | *0,9* | **-0.4** |
| Social security PLF 2013 (reform of self-employed payroll tax, higher tax on beer and tobacco, etc.) | 2.9 | *1.0* | -0.1 |
| LFR II 2012 (reversal of overtime exemption, limitation of tax breaks and employee savings, higher CSG wealth tax, capital income, etc.) | 5.3 | *0.8* | -0.2 |
| Pension reform (higher contributions) | 0.5 | *1.0* | 0.0 |
| **Other** | **0.8** | *0.6* | **0.0** |
| PLF 2013 (higher tax on vacant housing, tougher "automobile malus", etc.) | 0.9 | *0.6* | 0.0 |
| LFR II 2012 (lower VAT on books) | -0.1 | *1.0* | 0.0 |
| **Business**** | **12.2** | *0.8* | **-0.5** |
| **Corporate income tax** | **8** | *0.7* | **-0.3** |
| PLF 2013 (limits on financial expenses deductibility, reform of the "cinquième acompte", etc.) | 8 | *0.7* | -0.3 |
| **Payroll tax and social contributions** | **2.3** | *1.0* | **-0.1** |
| Social security PLF 2013 (higher CNRACL contribution rate, reform on wage tax, etc.) | 1.8 | *1.0* | -0.1 |
| Pension reform | 0.5 | *1.0* | 0.0 |
| **Other** | **1.9** | *0.5* | **-0.1** |
| PLF 2013 (sectoral measures on taxation of business insurance) (sectoral measures on taxation of business insurance) | 1.3 | *0.8* | -0.1 |
| LFR II 2012 (one-off contribution of oil industry, taxation of financial transactions, etc.) | 0.6 | *0.2* | 0.0 |
| **Total Business and Household Taxes and Contributions** | **27.9** | *0,8* | **-1,1** |
| **Structural saving on primary public expenditure** | **8.0** | *1.3* | **-0.5** |
| **Total fiscal impulse** | **35.9** | *0.9* | **-1.7** |

* This amount incorporates the downward revision of the yield initially foreseen in the PLF 2013 of the measure taxing capital gains at the personal income tax rate, which is to be offset by the extension of the exceptional 5% corporate income tax contribution for large corporations.

** This breakdown does not measure the final fiscal impact that is to be borne by households if the increase in business taxes is passed on in prices.

Sources : PLF 2013, Social security PLF 2013, LFR I and II 2012, OFCE calculations.

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[1] For more on this, see Creel, Heyer, Plane, 2011, "Petit précis de politique budgétaire par tous les temps", *Revue de l'OFCE*, no. 116, January 2011.

# What is the value of the fiscal multipliers today?

By [Xavier Timbeau](Xavier Timbeau)

We inherited higher public deficits and greatly increased public debts from the crisis (Table 1). Reducing these will require a major fiscal effort. But a programme that is too brutal and too fast will depress activity and prolong the crisis, not only compromising the fiscal consolidation effort but also locking the economies into a recessionary spiral. The value of the fiscal multiplier (the link between fiscal policy and economic activity) both in the short term and in the long term is thus a critical parameter for stabilizing the public finances and returning to full employment.

**Public deficit and public debt 2007-2012**

| In GDP points | Public deficit | | Net public debt minus financial assets | |
|---|---|---|---|---|
| | 2012 | Change 2012-2007 | 2012 | Change 2012-2007 |
| DEU | -0.9 | -1.1 | 52 | 9 |
| FRA | -4.5 | -1.7 | 66 | 31 |
| ITA | -1.7 | -0.1 | 96 | 9 |
| ESP | -5.4 | -7.3 | 54 | 37 |
| NLD | -4.3 | -4.4 | 43 | 15 |
| BEL | -2.8 | -2.7 | 82 | 9 |
| PRT | -4.6 | -1.4 | 81 | 32 |
| IRL | -8.4 | -8.5 | 82 | 82 |
| GRC | -7.4 | -0.6 | 134 | 52 |
| AUT | -2.9 | -1.9 | 48 | 17 |
| Euro area (EA11) | -3.0 | -2.3 | 63 | 20 |
| GBR | -7.7 | -4.9 | 74 | 46 |
| USA | -8.3 | -5.3 | 85 | 37 |
| JPN | -9.9 | -7.8 | 134 | 54 |

Source : OECD, Economic outlook 91.

When the multiplier (in the short term) is greater than approximately 2 (actually 1/*a*, *a* being the sensitivity of the public deficit to the economic cycle and valued at about 0.5 in the developed countries), then fiscal cutbacks produce such a decrease in activity that the short-term deficit increases with the cuts. When the multiplier is greater than approximately 0.7 (in fact, 1/(*a*+*d*), *d* being the ratio of debt to GDP), then fiscal restraint increases ratio of debt to GDP in the short term. In the longer term, things get complicated, and only a detailed modelling can help to understand in what circumstances today fiscal restraint would lead to a sustained reduction in the debt-to-GDP ratio. The value of the multiplier in the medium term is of course crucial (it is usually assumed to be null, or zero, but in the case of cost-effective public investment, this assumption does not hold), but hysteresis effects as well as changes in expectations about inflation or about sovereign interest rates (and therefore the critical gap, *i.e.* the gap between 10-year sovereign bond rates and the economy's nominal potential

growth rate) interact with changes in the debt and in GDP.

Until recently, most economists believed that the value of the multiplier depends on the composition of the fiscal stimulus (taxes, expenditure and the nature of taxes and expenditure), the size of the economy and its openness (the more open the economy, the lower its multiplier) and the existence of anticipations of a fiscal shock (an anticipated shock would have little effect, in the long term, it would have none, with only an unexpected shock having a temporary effect)[1]. Recent literature (since 2009) has taken an interest in the value of the fiscal multiplier in the short term in times of crisis . Two main conclusions emerge:

1. The multiplier is higher in "times of crisis" (in the short term or as long as the crisis lasts). In "times of crisis" means high unemployment or a very wide output gap. Another symptom may be a situation where safe long-term interest rates are very low (*i.e.* negative in real terms), suggesting a flight to safety (radical uncertainty) or a liquidity trap (expectations of deflation). Two theoretical interpretations are consistent with these manifestations of the crisis. One, price expectations are moving toward deflation, or radical uncertainty makes it impossible to form an expectation, which is consistent with very low safe interest rates and leads to the paralysis of monetary policy. Or second, more economic agents (households, firms) are subject to short-term liquidity constraints, perpetuating the recessionary spiral and preventing monetary policy from functioning. In one case as in the other, the fiscal multipliers are higher than in normal times because the expansionary fiscal policy (resp. restrictive) forces the economic agents to take on debt (resp. shed debt) collectively instead of individually. In "times of crisis" the multiplier is in play including when it is anticipated and its effect persists until a

return to full employment.

2. The multiplier is higher for expenditures than it is for compulsory levies. The argument in normal times is that higher compulsory levies acts as a disincentive and spending cuts as an incentive on the supply of labour. In a small open economy, when monetary policy also induces a real depreciation of the currency, fiscal restraint can increase activity, a result that has long allowed supporters of fiscal discipline to promise all kinds of wonders. But in times of crisis, in addition to the fact that the multipliers are higher, the logic applicable in normal circumstances is reversed. The use of taxes as disincentives for the labour supply or spending cuts as incentives does not work in an economy dominated by involuntary unemployment or overcapacity. It is in fact the expectations of a recession or of deflation that act as disincentives, which is another factor indicating high multipliers.

Econometric estimates (based on past experience of "times of crisis") lead to retaining a fiscal multiplier of around 1.5 (for an average mix of spending and compulsory levies).

Taking together 2011 and 2012, years in which a very strong fiscal impulse was carried out, confirms this econometric evaluation. By comparing on the one hand changes in the output gap from end 2010 to 2012 (on the abscissa) and on the other hand the cumulative fiscal impulse for 2011 and 2012, we obtain the short-term impact of the fiscal consolidation. Figure 1 depicts this relationship, showing a close link between fiscal restraint and economic slowdown.
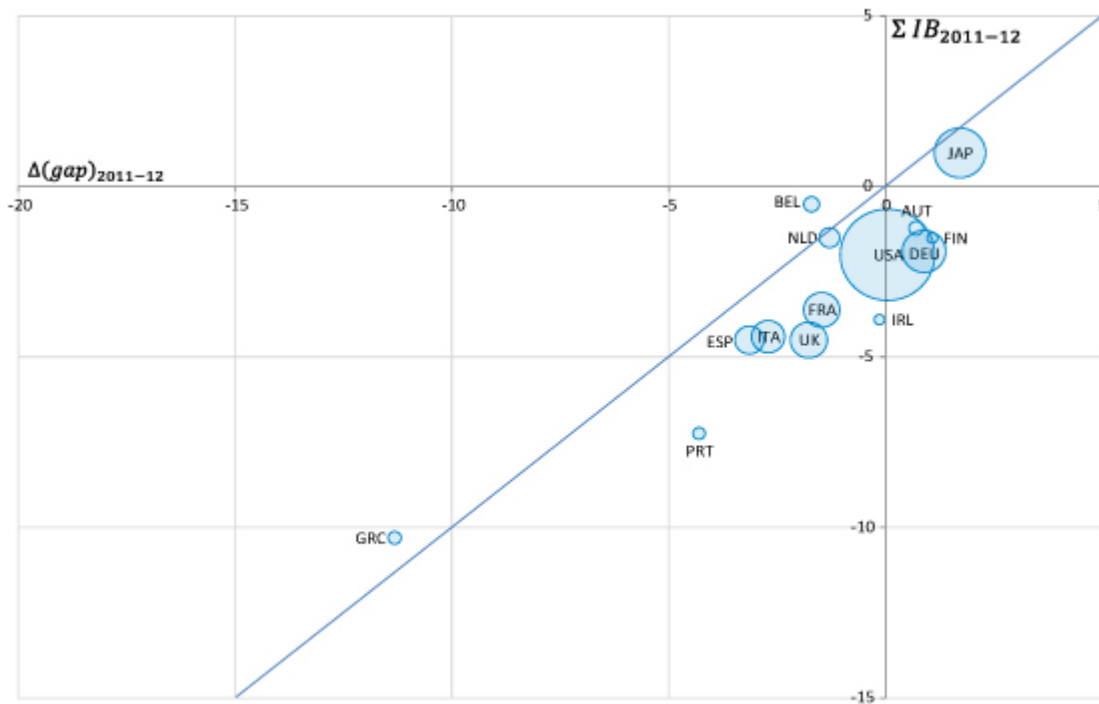
For most countries, the "apparent" multiplier is less than 1 (the lines connecting each of the bubbles are below the bisector, the "apparent" multiplier is the inverse of the slope of these lines). Figure 2 refines the evaluation. The changes in the output gap are in effect corrected for the "autonomous" dynamic of the closing of the output gap (if there had been no impulse, there would have been a closing of the output gap, which is estimated as taking place at the same rate as in the past) and for the impact of each country's budget cutbacks on the others through the channel of foreign trade. The bubbles in orange therefore replace the blue bubbles, integrating these two opposing effects, which are evaluated here while seeking to minimize the value of the multipliers. In particular, because the output gaps have never been so extensive, it is possible that the gaps are closing faster than what has been observed in the last 30 or 40 years, which would justify a more dynamic counterfactual and therefore higher fiscal multipliers.

Austria and Germany are exceptions. As these two countries

enjoy a more favourable economic situation (lower unemployment, better business conditions), it is not surprising that the multiplier is lower there. Despite this, the "corrected apparent" multiplier is negative. This follows either from the paradoxical effects of the incentives, or more likely from the fact that monetary policy is more effective and that these two countries have escaped the liquidity trap. But the correction provided here does not take into account any stimulus from monetary policy.

In the United States, the "2011-2012 corrected apparent" multiplier comes to 1. This "corrected apparent" multiplier is very high in Greece (~ 2), Spain (~ 1.3) and Portugal (~ 1.2), which is consistent with the hierarchy set out in point 1. This also suggests that if the economic situation deteriorates further, the value of the multipliers may increase, exacerbating the vicious circle of austerity.

For the euro zone as a whole, the "corrected apparent" multiplier results from the aggregation of "small open economies". It is thus higher than the multiplier in each country, because it relates the impact of the fiscal policy in each country to the whole zone and no longer just to the country concerned. The aggregate multiplier for the euro zone also depends on the composition of the austerity package, but especially to the place where the measures are being implemented. However, the biggest fiscal impulses are being executed where the multipliers are highest or in the countries in the deepest crisis. The result is that the aggregate multiplier for the euro zone is 1.3, significantly higher than that derived from the US experience.

A comparison of the fiscal plans for 2011 and 2012 with the economic cycle in those years yields a high estimate for the fiscal multipliers. This confirms the dependence of the multiplier on the cycle and constitutes a serious argument against the austerity approach, which is to be continued in 2013. Everything indicates that we are in a situation where

[austerity is leading to disaster](#).

## Graphe 2 : Changes in the output gap and the impulse 2011-2012
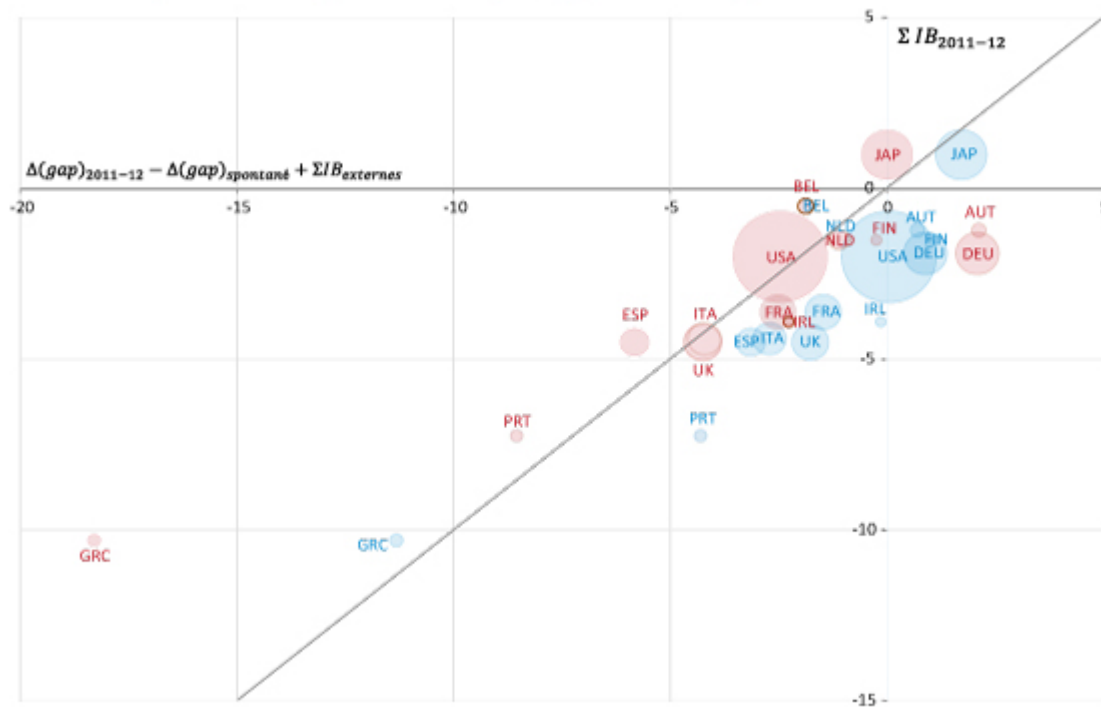


Source: OECD, *Economic Outlook 91*, June 2012. The year 2012 is a projection (OFCE forecast October 2012). The area of the bubbles is proportional to real GDP in 2011 ($ PPP).

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[1] There has been an intense debate about the theoretical and especially the empirical validity of these assertions (see [Creel, Heyer and Plane 2011](#) and [Creel, Ducoudré, Mathieu and Sterdyniak 2005](#)). Recent empirical work undertaken for example by the IMF has contradicted the analyses made in the early 2000s, which concluded that anti-Keynesian effects dominate Keynesian effects. Thus, at least with regard to the short term, before the crisis and in "normal times", the diagnosis today is that the fiscal multipliers are positive. The endogeneity of measurements of a fiscal impulse by simply varying the structural deficit interfered with the empirical analysis. The use of a narrative record of fiscal impulses addresses this issue and significantly alters estimates of the multipliers. In most macroeconomic models (including dynamic stochastic general equilibrium — DGSE — models), the fiscal

multipliers are also positive in the short term (on the order of 0.5 for a pure fiscal shock "in normal times"). In the long run, the empirical analysis does not tell us much, as the noise drowns out any possibility of measurement. The long term therefore reflects mainly an *a priori* theory that remains largely dominated by the idea that fiscal policy can have no long-term effect. However, in the case of public investment or of possible hysteresis, the assumption of a non-null effect in the long run seems more realistic.

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# France: will the war of the 3% take place?

By [Eric Heyer](#)

*This text summarizes the [OFCE's October 2012 forecasts for the French economy](#).*

The French economy is expected to see average annual growth of 0.1% in 2012 and 0.0% in 2013. This performance is particularly poor and far from the path that an economy recovering from a crisis would normally experience.

Four years after the onset of the crisis, the French economy has real potential for a rebound: this should lead to spontaneous average growth of about 3.0% per year in 2012 and 2013, making up some of the output gap built up since the start of the crisis. But this spontaneous recovery is being hampered, mainly by the establishment of budgetary savings plans in France and throughout Europe. The fiscal consolidation strategy imposed by the European Commission is

likely to slice nearly 6 percentage points off GDP in France during 2012 and 2013.

**Table 1. The brakes on growth in France**

En points of GDP

| Rythm | ... quaterly | | ... annually | |
|---|---|---|---|---|
| | 2012 | 2013 | 2012 | 2013 |
| Spontaneous recovery | 0,8 | 0,8 | 2,1 | 3,1 |
| Budget impact | -0,4 | -0,4 | -1,6 | -1,7 |
| Oil shock | -0,05 | 0,0 | -0,2 | 0,0 |
| External environment | -0,4 | -0,3 | -1,4 | -1,2 |
| Achievement | | | -1,0 | -0,2 |
| Growth forecasts | -0,04 | 0,04 | 0,1 | 0,0 |

Sources : INSEE, OFCE calculations.

By setting a pace that is far from its potential, the expected growth will increase the output gap accumulated since 2008 and will lead to a further deterioration on the labour market. The unemployment rate will rise steadily and hit 11% by late 2013.

Moreover, the reduction of the budget deficit expected by the Government due to the implementation of its consolidation strategy — the target for the general government deficit is 3% of GDP in 2013 — will be partially undermined by the shortfall in tax revenue due to weak growth. The general government deficit will come to 3.5% in 2013.

Under these conditions, should the government do whatever it can to fulfil its commitment to a 3% deficit in 2013?

In a context of financial uncertainty, being the only State not to keep its promise of fiscal consolidation is a risk, *i.e.* of being punished immediately by an increase in the financial terms on the repayment of its debt. This risk is real, but limited. The current situation is that of a "liquidity trap" and abundant savings. The result is a "flight to quality" phenomenon on the part of investors seeking safe investments. But among these are both German and French government bonds. Under these conditions, reducing the government deficit by 1 GDP point instead of 1.5 point would

have very little impact on French bond rates.

However, maintaining a target of a 3% deficit in 2013 could have a dramatic impact on economic activity and employment in France. We simulated a scenario in which the French government maintains its budgetary commitment regardless of the costs and the economic situation. If this were to occur, it would require the adoption of a new programme of budget cuts in the coming months in the amount of 22 billion euros.

This strategy would cut economic activity in the country by 1.2% in 2013. It would lead to a further increase in the unemployment rate, which would reach 11.7% at year end, nearly 12%. As for employment, this obstinacy would intensify job losses, costing nearly 200,000 jobs in total.

A darker scenario is also possible: according to our forecasts, and taking into account the draft budget bills known and approved, no major European country would meet its deficit reduction commitments in 2013. By underestimating the difficulty of reaching inaccessible targets, there is a high risk of seeing the euro zone countries locked into a spiral where the nervousness of the financial markets would become the engine driving ever greater austerity. To illustrate this risk, we simulated a scenario in which the major euro zone countries (Germany, France, Italy and Spain) implement new austerity measures to meet their deficit targets in 2013. Adopting such a strategy would result in a strong negative shock to economic activity in these countries. For the French economy, it would lead to additional austerity that either at the national level or coming from its euro zone partner countries would cause a severe recession in 2013. French GDP would fall by more than 4.0%, resulting in a further increase in the unemployment rate, which would approach 14%.

## Table 2. Illustrative scenarios of risks to French growth

In %

|  | 2011 | 2012* | 2013* |
|---|---|---|---|
| **Central scenario** | | | |
| GDP | 1,4 | 0,1 | 0,0 |
| Gov't deficit    *(in GDP points)* | -7,1 | -4,4 | -3,5 |
| Unemployment rate | 9,4 | 10,2 | 11,0 |
| Market employment | 104 | -95 | -166 |
| **Scenario where France alone meets its budget commitments** | | | |
| GDP | | | -1,2 |
| Gov't deficit *(in GDP points)* | | | -3,0 |
| Unemployment rate | | | 11,7 |
| Market employment *(in 1000s)* | | | |
| Change | | | -361 |
| Deviation from central scenario | | | -195 |
| **Scénario where euro zone countries meet their budget commitments** | | | |
| GDP | | | -4,6 |
| Gov't deficit *(in GDP points)* | | | -3,0 |
| Unemployment rate | | | 18,8 |
| Market employment *(in 1000s)* | | | |
| Change | | | -910 |
| Déviation from central scenario | | | -744 |

\* OFCE forecast October 2012
*Sources : INSEE ; OFCE calculations  e-mod.fr.*

# Less austerity = more growth and less unemployment

Eric Heyer and Xavier Timbeau

The European Commission has just released its spring forecast, which anticipates a recession in 2012 for the euro zone ("mild" in the words of the Commission, but still -0.3%), which is in line with the OFCE's economic analysis of March 2012.

The brutal fiscal austerity measures launched in 2010, which were intensified in 2011 and tightened even further in 2012 virtually throughout the euro zone (with the notable exception of Germany, Table 1 and 1a), are hitting activity in the zone hard. In 2012, the negative impact on the euro zone resulting from the combination of raising taxes and reducing the share of GDP that goes to expenditure will represent more than 1.5 GDP points. In a deteriorating fiscal situation (many euro zone countries had deficits of over 4% in 2011) and in order to continue to borrow at a reasonable cost, a strategy of forced deficit reduction has become the norm.

**Table 1. The euro zone in 4 macroeconomic aggregates from 2009 to 2012**

|  | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| GDP growth (%/yr) | -4,4 | 1,8 | 1,5 | -0,4 |
| Public deficit (% GDP) | -5,5 | -5,5 | -3,6 | -2,9 |
| Jobless rate (% active pop) | 9,6 | 10,1 | 10,2 | 10,9 |
| Fiscal impulse (% GDP) | 1,7 | -0,3 | -1,1 | -1,5 |

*Sources :* National accounts, OFCE calculations and forecasts.

This strategy is based on declarations that the 3% ceiling will be reached by 2013 or 2014, with balanced budgets to follow by 2016 or 2017 in most countries. However, these goals seem to be overly ambitious, as no country is going to meet its targets for 2013. The reason is that the economic slowdown is undermining the intake of the tax revenue needed to balance budgets. An overly optimistic view of the impact of fiscal restraint on activity (the so-called fiscal multiplier) has been leading to unrealistic goals, which means that GDP growth forecasts must ultimately be systematically revised downward. The European Commission is thus revising its spring forecast for the euro zone in 2012 downward by 0.7 point compared to its autumn 2011 forecast. Yet there is now a broad consensus on the fact that fiscal multipliers are high in the short term, and even more so that full employment is still out of reach (here too, many authors agree with the analyses made by the OFCE). By underestimating the difficulty of reaching

inaccessible targets, the euro zone members are locked in a spiral where jitters in the financial markets are driving ever greater austerity.

Unemployment is still rising in the euro zone and has hardly stopped increasing since 2009. The cumulative impact on economic activity is now undermining the legitimacy of the European project itself, and the drastic remedy is threatening the euro zone with collapse.

What would happen if the euro zone were to change course in 2012?

Assume that the negative fiscal impulse in the euro zone is on the order of -0.5 percent of GDP (instead of the expected total of -1.8 GDP points). This reduced fiscal effort could be repeated until the public deficit or debt reaches a fixed target. Because the effort would be more measured than in current plans, the burden of the adjustment would be spread out more fairly over the taxpayers in each country, while avoiding the burden of drastic cuts in public budgets.

Table 2 summarizes the results of this simulation. Less austerity leads to more growth in all the countries (Table 2a), and all the more so as the fiscal consolidation announced for 2012 intensifies. Our simulation also takes into account the impact of the activity in one country on other countries through trade. Thus, Germany, which has an unchanged fiscal impulse in our scenario, would experience an 0.8 point increase in growth in 2012.

### Table 2. Fiscal impulse of -0.5 GDP point in the euro zone in 2012

|  | GDP (%/yr) | | Public deficit (% GDP) | | Jobless rate (% active pop.) | |
| --- | --- | --- | --- | --- | --- | --- |
|  | 2011 | 2012 | 2011 | 2012 | 2011 | 2012 |
| 2012, under current plans | 1,5 | -0,4 | -3,6 | -2,9 | 10,2 | 10,9 |
| 2012, if 0.5% GDP impulse |  | 1,7 |  | -3,1 |  | 9,7 |

Note: The impulse is the change in the structural deficit. The structural deficit is the public deficit excluding the impact of the economic cycle. A negative impulse reflects a restrictive fiscal policy. Here the public («administrations publiques», or "APU") deficit includes the central state, regional government and social security agencies.

*Sources:* National accounts, OFCE calculations and forecasts.

In the "less austerity" scenario, unemployment would decline instead of continuing to increase. In all the countries except Greece, the public deficit would be lower in 2012 than in 2011. Admittedly, this reduction would be less than in the initial scenario in certain countries, in particular those that have announced strong negative impulses (Spain, Italy, Ireland, Portugal and … Greece), which are the ones most mistrusted by the financial markets. In contrast, in some countries, such as Germany and the Netherlands, the government deficit would shrink more than in the initial scenario, with the indirect positive effect of stronger growth outweighing the direct effect of less fiscal consolidation. For the euro zone as a whole, the public deficit would be 3.1 percentage points of GDP, against 2.9 points in the initial scenario. It is a small difference compared to more favorable growth (2.1%), along with lower unemployment (-1.2 points, Table 2) instead of an increase as in the initial scenario.

The key to the "less austerity" scenario is to enable the countries in greatest difficulty, those most obliged to implement the austerity measures that are plunging their economies into the vicious spiral, to reduce their deficits more slowly. The euro zone is split into two camps. On the one hand, there are those who are demanding strong, even brutal austerity to give credibility to the sustainability of public finances, and which have ignored or deliberately underestimated the consequences for growth; on the other are those who, like us, are recommending less austerity to sustain more growth and a return to full employment. The first have failed: the sustainability of public finances has not been secured, and recession and the default of one or more countries are threatening. The second strategy is the only way to restore social and economic — and even fiscal — stability, as it combines a sustainable public purse with a better balance between fiscal restraint and employment and growth, as we proposed in a [letter to the new President of the French Republic](#).

## Table 1a. Details on the 4 macroeconomic aggregates for the euro zone from 2009 to 2012

| | GDP growth (%/yr) | | | | Public deficit (% GDP) | | | | Jobless rate (% active pop.) | | | | Fiscal impulse (% GDP) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2012 | 2009 | 2010 | 2011 | 2012 | 2009 | 2010 | 2011 | 2012 | 2009 | 2010 | 2011 | 2012 |
| DEU | -5,1 | 3,6 | 3,1 | 0,3 | -3,2 | -4,3 | -1,0 | -1,1 | 7,8 | 7,1 | 6,0 | 5,5 | 0,7 | 1,2 | -0,9 | -0,3 |
| FRA | -2,6 | 1,4 | 1,7 | 0,2 | -7,5 | -7,1 | -5,2 | -4,4 | 9,2 | 9,4 | 9,3 | 9,8 | 2,5 | -0,7 | -1,7 | -1,7 |
| ITA | -5,5 | 1,8 | 0,5 | -1,7 | -5,4 | -4,6 | -3,8 | -2,8 | 7,8 | 8,4 | 8,4 | 9,4 | 0,8 | -0,4 | -1,0 | -2,9 |
| ESP | -3,7 | -0,1 | 0,7 | -1,1 | -11,2 | -9,3 | -8,5 | -6,5 | 18,0 | 20,1 | 21,7 | 23,5 | 4,1 | -1,9 | -1,2 | -3,4 |
| NLD | -3,5 | 1,6 | 1,3 | -1,1 | -5,6 | -5,1 | -5,0 | -4,5 | 3,7 | 4,5 | 4,5 | 5,4 | 3,8 | -1,5 | -0,2 | -1,9 |
| BEL | -2,7 | 2,3 | 1,9 | 0,1 | -5,8 | -4,1 | -4,0 | -3,4 | 7,9 | 8,3 | 7,2 | 7,6 | 1,8 | -0,3 | -0,1 | -1,4 |
| PRT | -2,9 | 1,4 | -1,5 | -2,9 | -10,1 | -9,8 | -4,0 | -4,5 | 10,7 | 12,1 | 12,9 | 13,4 | 4,9 | -0,6 | -5,5 | -3,0 |
| IRL | -7,0 | -0,4 | 0,7 | -0,3 | -14,4 | -32,0 | -10,1 | -8,7 | 11,9 | 13,7 | 14,5 | 14,9 | 3,7 | -4,1 | -2,5 | -3,0 |
| GRC | -2,3 | -4,4 | -6,2 | -5,3 | -15,8 | -10,6 | -9,3 | -7,3 | 9,5 | 12,5 | 17,2 | 19,5 | 3,4 | -7,9 | -5,6 | -5,3 |
| FIN | -8,4 | 3,7 | 2,8 | 0,7 | -2,5 | -2,5 | -1,2 | -0,9 | 8,8 | 8,4 | 7,8 | 7,5 | 0,4 | -1,5 | -1,1 | -1,1 |
| AUT | -3,6 | 2,5 | 3,0 | 0,4 | -4,1 | -4,4 | -3,4 | -3,0 | 4,8 | 4,4 | 4,2 | 4,5 | 0,4 | 0,6 | -0,5 | -1,2 |

*Note*: DEU Germany; FRA France; ITA Italy; ESP Spain; NLD Netherlands; BEL Belgium; PRT Portugal; IRL Ireland; GRC Greece; FIN Finland; AUT Austria.
*Sources*: National accounts, OFCE calculations and forecasts.

## Table 2b. Fiscal impulse of -0.5 GDP point in the euro zone countries in 2012

| | DEU | FRA | ITA | ESP | NLD | BEL | PRT | IRL | GRC | FIN | AUT |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **GDP growth rate (%/yr)** | 1,1 | 2,2 | 1,4 | 2,6 | 2,1 | 1,8 | 0,7 | 2,8 | 0,2 | 1,9 | 1,8 |
| Difference with Table 1a | 0,8 | 2,0 | 3,1 | 3,7 | 3,2 | 1,7 | 3,6 | 3,1 | 5,5 | 1,2 | 1.4 |
| Of which:  - direct impact | 0,0 | 1,2 | 2,4 | 2,9 | 2,5 | 0,9 | 2,5 | 2,5 | 4,8 | 0,6 | 0,7 |
|                  - impact *via* trade | 0,8 | 0,8 | 0,7 | 0,8 | 0,7 | 0,8 | 1,1 | 0,6 | 0,7 | 0,6 | 0.7 |
| **Public deficit (% GDP)** | -0,7 | -4,6 | -3,7 | -7,5 | -4,3 | -3,4 | -5,2 | -9,7 | -9,4 | -0,9 | -3,0 |
| Difference with Table 1a | 0,4 | -0,2 | -0,9 | -1,0 | 0,2 | 0,0 | -0,7 | -1,0 | -2,1 | 0,0 | 0,0 |
| **Jobless rate (% active pop.)** | 5,1 | 8,8 | 7,9 | 21,6 | 3,8 | 6,7 | 11,6 | 13,3 | 16,8 | 6,9 | 3,8 |
| Difference with Table 1a | -0,4 | -1,0 | -1,5 | -1,9 | -1,6 | -0,9 | -1,8 | -1,5 | -2,7 | -0,6 | -0,7 |

*Sources*: National accounts, OFCE calculations and forecasts.

# 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.

# 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.

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# 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).