

Trump's budget policy: Mortgaging the future?

By [Christophe Blot](#)

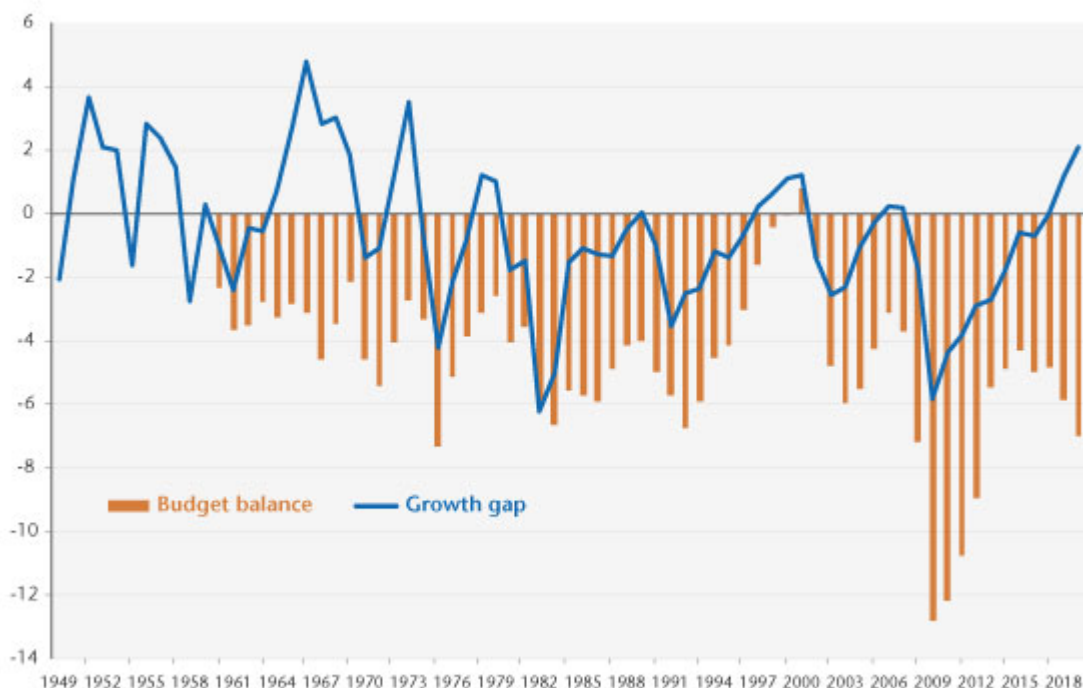
While the momentum for growth has lost steam in [some countries](#) – Germany, France and Japan in particular – GDP in the United States is continuing to rise at a steady pace. Growth could even pick up pace in the course of the year as a highly expansionary fiscal policy is implemented. In 2018 and 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 end of a cycle?

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This text is based on the 2018-2019 outlook for the world economy and the euro zone, a full version of which is available [here](#) [in French].

Global growth remained buoyant in 2017, allowing both the recovery and the reduction in unemployment to continue, especially in the advanced countries where growth rose to 2.3%, up from 1.6% the previous year. Although there are still a few countries where GDP has not recovered to its pre-crisis level, this improvement will gradually erase the stigma of the Great Recession that hit the economy 10 years ago. Above all, activity seemed to be gathering pace at the end of the year as, with the exception of the United Kingdom, annual GDP growth continued to pick up pace (Figure 1). However, the gradual return of the unemployment rate to its pre-crisis

level and the closing of growth differentials, particularly in the United States and Germany, which had widened during the crisis, could foreshadow a coming collapse of growth. The first available estimates of growth in the first quarter of 2018 seem to lend credence to this assumption.

After a period of improvement, euro zone growth stalled in the first quarter of 2018, falling from 2.8% year-on-year in the fourth quarter of 2017 to 2.5%. While the slowdown has been more significant in Germany and France, it can also be seen in Italy, the Netherlands and, to a lesser extent, Spain (Figure 2). As for the United Kingdom, the slowdown is continuing as the prospect of Brexit draws nearer, while the country's budgetary policy is also more restrictive than in the other European countries. Japan is experiencing rather more than a slowdown, with quarterly GDP growth even falling in the first quarter. Finally, among the main advanced economic countries, growth is still gathering steam only in the United States, where GDP rose 2.9% year-on-year in the first quarter of 2018.

Does the slowdown testify to the end of the growth cycle? Indeed, the gradual closing of the gaps between potential GDP and actual GDP would steadily lead countries towards their long-term growth paths, with estimates converging at what is indicated to be a lower level. In this respect, Germany and the United States would be representative of this situation since the unemployment rate in the two countries is below its pre-crisis level. In these conditions, their growth would be slowed. It is clear that this has not been the case in the United States. We must therefore refrain from any generalized conclusion. In fact, despite the fall in unemployment, other indicators – the employment rate – provide a more nuanced diagnosis of the improvement in the state of the labour market in the US. Furthermore, in the case of France this performance is mainly the consequence of the fiscal calendar, which caused a decrease in household purchasing power in the first quarter

and therefore a slowdown in consumption [\[1\]](#). This would therefore amount more to an air pocket than the sign of a lasting slowdown in French growth.

Above all, the factors that have supported growth will not generally be reversed. Monetary policy will remain expansionary even if a normalization is already underway in the United States, with the euro zone to start in 2019. On the fiscal side, the focus is more often neutral and should become highly expansionary for the United States, pushing growth above its potential. Finally, there are many uncertainties about estimates of the growth gap, meaning that maneuvering room might not necessarily be exhausted in the short term. An economic recovery is in fact still not being accompanied by a return of inflationary pressures or sharp wage increases, which would then indicate that the labour market is overheating. We anticipate continued growth in the industrialized countries in 2018 and accelerating growth in the emerging countries, bringing global growth to 3.7% in 2018. Growth should then peak, slowing down very slightly in 2019 to 3.5%. In the short term, the growth cycle would not then be over.

Figure 1. Growth in the advanced countries

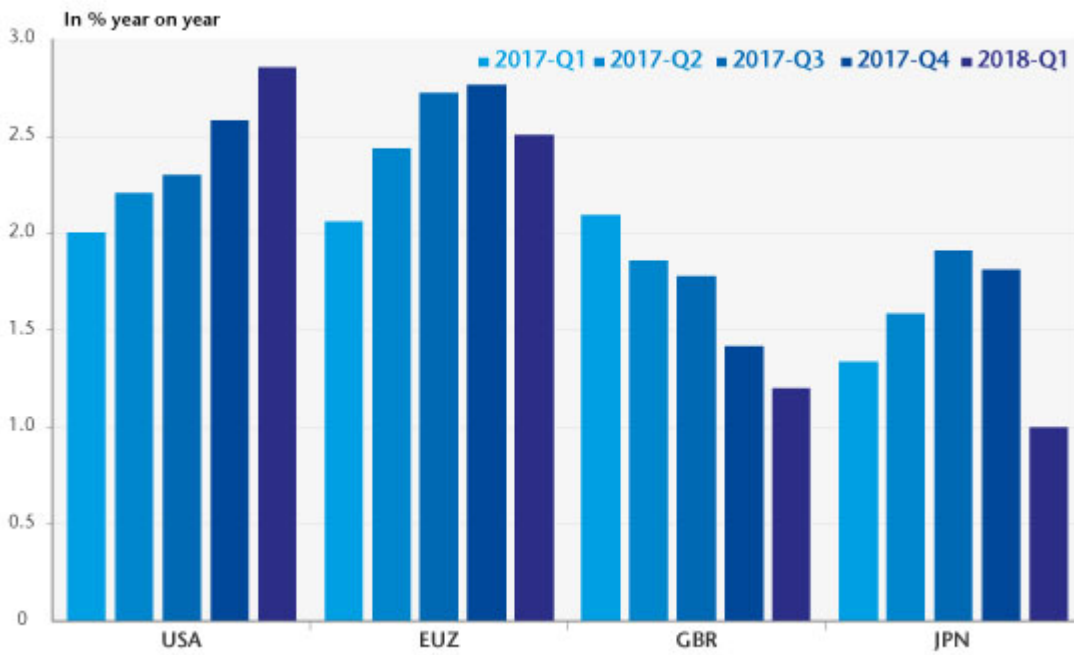
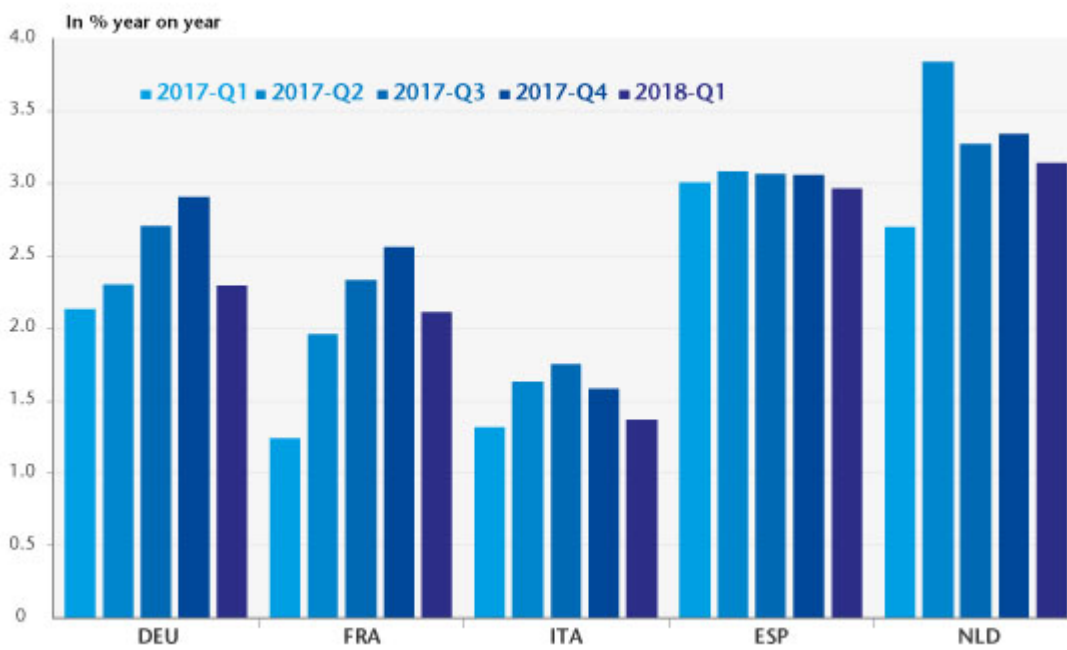


Figure 2. Growth in eurozone



The French policy mix and support for private R&D: What realities for what results?

By Benjamin Montmartin

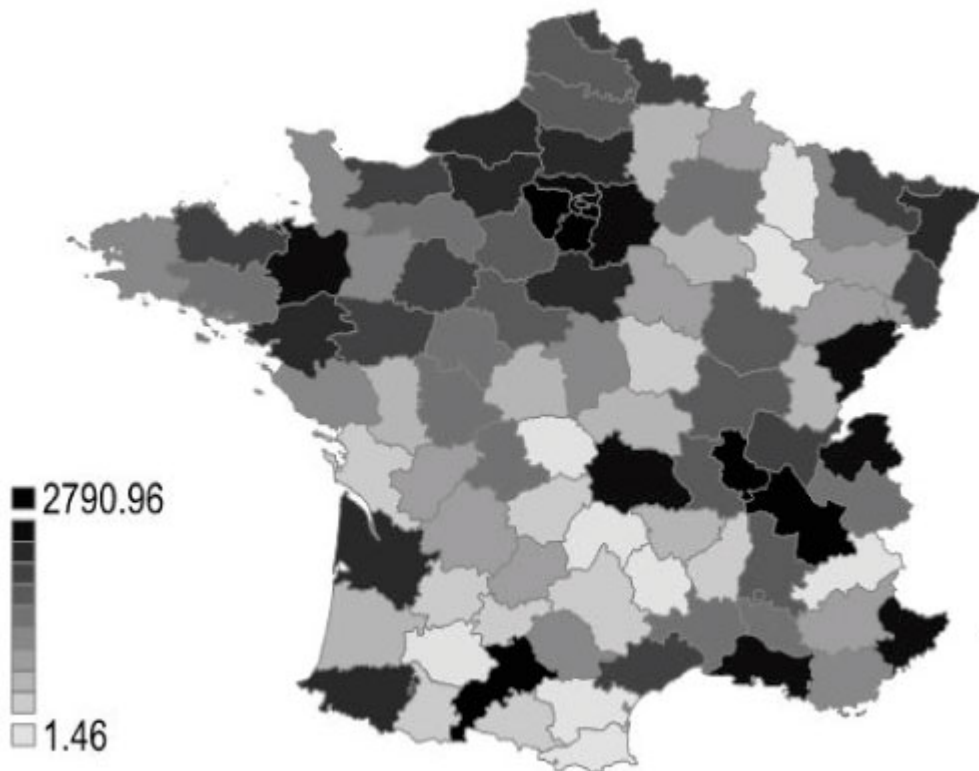
France can be viewed as a unique experimental laboratory in terms of public support for investment in R&D. Indeed, since the Research Tax Credit was reformed in 2008, France has become the most generous country in the OECD in terms of tax incentives for R&D (OECD, 2018a.) In 2014, the tax credit alone represented (MESRI, 2017) a total of nearly 6 billion euros for the State, and the specific taxation scheme on patent grant revenues (15%) costs the State between 600 and 800 million euros per year. In addition to these losses in tax revenue, there are the various measures to directly support innovation (grants, loans at subsidized rates, etc.) which are financed mainly through the Public Investment Bank (BPI), the Competitiveness centres (PC), local authorities and the European Commission. This direct support accounted for around 3.5 billion euros in 2014. The total cost of all these support measures today comes to over 10 billion euros per year, almost half a percentage point of GDP.

While innovation is one of the main drivers of growth, this is not enough to justify this level of public spending. These devices must also achieve their objective. And from this point of view, the results of the empirical studies evaluating support systems for R&D and innovation are very mixed (Salies, 2018). Moreover, there does not seem to be a direct link between the generosity of States and the level of business investment in R&D. In this respect, a simple comparison between Germany and France is instructive and cannot be explained solely by sectoral differences. In 2015 (OECD, 2018b) private sector spending on R&D in France accounted for

1.44% of GDP compared to 2.01% in Germany, while public funding for these expenditures was around 5% in Germany against almost 40% in France.

In this context, it seems necessary to better understand the performance of the French policy-mix with respect to private investment in R&D. A recent [OFCE working paper](#) reviews the effect of State aid on R&D spending by French companies. The article differs from existing studies in two main ways. First, instead of focusing on the ability of a particular instrument to generate an additionality, it simultaneously analyzes the impact of the tax credit and the various direct aids in accordance with their institutional source: local, national or European. Second, it assesses the extent to which the geographic structuring of innovation activities in France might influence the effectiveness of R&D support policies. Indeed, unlike Germany, where the geography of innovation is marked by a continuum between innovative territories (European Commission, 2014), France seems more prone to shadow effects[1], as the most innovative territories (the “hubs”) are dispersed and often surrounded by territory that is not very innovative, as shown in the figure below.

Private spending on R&D (in million euros, average 2001-2011)



Source: MESRI, author's calculations.

Our analysis uses data from firms aggregated at the departmental level over the 2001-2011 period and clearly shows the importance of the spatial organization of innovative activities for the effectiveness of innovation policy. Indeed, it appears that the specificity of the geography of R&D investment in France generates a negative spatial dependence, that is to say, that the hubs are strengthened at the expense of the territories lagging behind. Policies that fail to take this dependence into account will have an overall weaker effect.

And that's exactly what our results show. Indeed, if we do not take into account this spatial dependence, it appears that the instruments studied (tax credit and the various subsidies) are as a whole capable of generating a significant additionality effect on investment in R&D. On the other hand, if we take into account this dependency, only the national subsidies seem to be able to generate such an effect. In other words, only national grants are able to generate benefits that help all

the territories.

In our opinion, this result can be explained by the fact that national grants finance more collaborative projects involving actors from different territories and are therefore more likely to make use of complementarity. Conversely, the tax credit is not targeted geographically and does not particularly favour collaborative projects. Local grants primarily finance projects involving local forces, while European grants favour partnerships with foreign organisations. Thus, these last three sources of financing are more likely to encourage competition effects than complementarity effects between territories.

From a more overall viewpoint, our results therefore underline a nuanced effectiveness of the French policy-mix to promote R&D, as no policy studied seems to generate a significant windfall effect. Nevertheless, changes in the French policy-mix over the last decade, marked by a very pronounced increase in non-geographically targeted policies (tax credit) and, to a lesser extent, competitive policies (local subsidies) seems rather to indicate a decline in its ability to generate a very significant additionality effect.

[1] “Shadow effects” refer to the idea that a territory’s increasing attractiveness often comes at the detriment of other territories, due in particular to the impact of competitiveness issues.

References

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The French economy: Lasting or transitory slowdown?

By the OFCE France team

On Friday, April 27, the INSEE published the national accounts for the first quarter of 2018. With growth of 0.3%, the French economy seems to be slowing down, even though after five years of sluggish growth (0.8% on average over the period 2012-16) a recovery finally materialized in 2017 when GDP rose 2%. While the quarterly profile of GDP growth in 2018 will be marked by the timing of fiscal measures, which will affect purchasing power (rise in indirect taxation and the CSG tax) and thus the trajectory of household consumption, the impact, which is anticipated in [our spring forecast](#) (Table), should be only provisional. Household purchasing power should increase in the

following quarters, with a sharp acceleration at the end of the year driven by the fall in the housing tax and the second tranche of reductions in social security contributions.

The increase in consumption, weak in the first half and strong in the second, will therefore lead growth to pick up pace through the year, from 0.3% in the first quarter to 0.7% by year end. In 2019, as a result of the rise in the tax measures to shore up household purchasing power, the latter will increase by 2.4% (from 1.6% in 2018), boosting consumption for the year as a whole (2.2% in 2019 after 1.5% in 2018), despite a further rise in indirect taxation.

Business investment is expected to continue its robust growth in 2018 and 2019, supported by the ongoing improvement in profit rates, the continued low cost of capital, and growing demand, which is keeping the utilization rate at a high level. After shrinking for several years, general government investment is set to rise again in 2018 and 2019, with the gradual roll-out of the Grand Plan d'Investissement [Major Investment Plan] and the goal of maintaining investment by local authorities. Household investment should slow, as indicated by the downturn in housing demand surveys and the outlook for housing starts, probably in connection with the reduction in budget allocations for housing and with the wait-and-see attitude on the construction market following the discussion to be expected about the ELAN bill.

A pick-up in exports, confirmed by favorable survey trends, record levels of exporter margins and strong productive investment will translate into strengthening export market shares. Given the dynamic economic environment in the euro zone, foreign trade will no longer be a drag on France's growth in 2018 and 2019.

Given this robust growth in 2018 and 2019, job creation, driven by the market sector, will remain dynamic (+194,000 in 2018 and +254,000 in 2019), which will push down the

unemployment rate to 8.4% by the end of 2018 and to 7.9% by the end of 2019 (compared to 8.6% in the fourth quarter of 2017). On the other hand, the sharp fall in new government-assisted contracts in 2018 will slow the pace of the reduction in unemployment, despite the ramp-up of the Plan Formation et de la Garantie jeunes (Training Plan and Youth Guarantee).

The public deficit will be reduced only slowly (2.4% of GDP in 2018 and 2.5% in 2019, after 2.6% in 2017), but this masks a sharp improvement in the government balance, which will reach 1.6% in 2019 excluding the one-off measure related to the conversion of the CICE credit into reductions in social contributions. However, deficit reduction should be sufficient to ensure that France leaves the corrective arm of the Stability Pact and to begin to reduce the public debt (from 97% of GDP in 2017 to 95.4% in 2019).

Tableau. France: Summary of forecasts

	2017				2018				2019				2016	2017	2018	2019
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
GDP	0.7	0.6	0.5	0.7	0.3	0.4	0.5	0.7	0.5	0.5	0.5	0.6	1.1	2.0	2.0	2.1
GDP per capita	0.6	0.5	0.4	0.6	0.2	0.3	0.4	0.6	0.4	0.4	0.4	0.5	0.7	1.5	1.6	1.7
Public consumption	0.2	0.3	0.5	0.2	0.2	0.4	0.5	0.8	0.5	0.5	0.5	0.6	2.1	1.3	1.5	2.2
Consumption	0.3	0.5	0.6	0.3	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1	1.2	1.6	1.2	0.6
Total GFCF, of which:	1.7	0.9	0.9	1.1	0.7	0.9	0.9	0.9	0.7	0.7	0.7	0.8	2.7	3.8	3.6	3.1
NFCs & Individual firms	2.4	1.0	1.1	1.5	0.8	1.1	0.9	1.1	0.7	0.7	0.8	0.9	3.4	4.4	4.3	3.5
Households	1.8	1.4	0.9	0.6	0.5	0.4	0.5	0.4	0.2	0.3	0.2	0.2	2.4	5.3	2.5	1.3
Public authorities	-0.6	0.1	-0.2	0.5	0.8	0.9	1.0	1.0	1.0	1.0	1.0	1.0	-0.1	-1.0	2.6	4.0
Exports of goods & services	-0.7	2.2	1.0	2.5	0.6	0.4	0.8	1.0	1.0	0.8	0.9	1.0	1.9	3.3	4.6	3.6
Imports of goods & services	1.2	0.0	2.2	0.3	0.8	0.9	0.8	1.1	1.0	0.7	0.8	0.8	4.2	4.1	3.5	3.6
<i>Contributions:</i>																
Domestic demand excl. inventories	0.6	0.5	0.6	0.5	0.3	0.5	0.5	0.7	0.5	0.5	0.5	0.6	2.0	1.9	2.0	2.1
Change in inventories	0.7	-0.5	0.3	-0.4	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.4	-0.1	0.0
Foreign trade	-0.6	0.7	-0.4	0.7	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	-0.8	-0.3	0.2	0.0
Consumer prices (HCPI)*	1.5	1.0	0.9	1.2	1.6	1.2	1.5	1.4	1.3	1.4	1.7	1.8	0.3	1.2	1.4	1.6
Unemployment rate	9.3	9.1	9.3	8.6	8.6	8.6	8.5	8.4	8.3	8.2	8.1	7.9	9.8	9.1	8.5	8.1
Public deficit, % of GDP													-3.4	-2.6	-2.4	-2.5
Public debt, % of GDP													96.6	97.0	96.6	95.4
Fiscal impulse, GDP points**													0.0	0.2	0.0	-0.2
Euro zone GDP	0.6	0.7	0.7	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.5	1.8	2.5	2.3	1.9

* for the quarters, year on year; for the years, annual average. In grey, OFCE forecasts.

** measured as the inverse of the structural fiscal effort.

Sources: INSEE, OFCE forecasts April 2018.