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.

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[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'Erasmo 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.

Flexibility versus the new fiscal effort – the last word has not been spoken

By Raul Sampognaro

On 13 January, the Juncker Commission clarified its position on the flexibility that the Member States have in implementing the Stability and Growth Pact (SGP). The new reading of the SGP should result in reining in the fiscal consolidation required for certain countries[1]. Henceforth, the Commission can apply the "structural reform clause" to a country in the corrective arm of the Pact[2], whereas previously this was only possible for countries in the Pact's preventive arm[3]. This clause will allow a Member State to deviate temporarily from its prior commitments and postpone them to a time when the fruits of reform would make adjustment easier. In order for the Commission to agree to activate the clause, certain conditions must be met:

– The reform plan submitted by the Member State must be major and detailed, and approved by the Government or the National Parliament; its timetable for implementation must be explicit and credible;

– The plan must have a favourable impact on potential growth and / or the public finances in the medium-term. The quantification of the impact should be carried out transparently and the Member State must submit the relevant documentation to the Commission;

– The Member State must make a structural budget improvement of at least 0.5 GDP point.

In this new context, France has reforms it can point to, such as the regional reform and the law on growth and activity, the so-called Macron law. According to OECD calculations from October 2014, the reforms already underway or being adopted [4] could boost GDP by 1.6 points over the next 5 years while improving the structural budget balance by 0.8 GDP point[5] (the details of the impacts estimated by the OECD are shown in Table 1).

Table 1. Impact on GDP of the reforms underway or announced

In points

Reforms	Impact on GDP at 5 years	Impact on GDP at 10 years
Reforms underway	1.2	3.0
Greater competition (administrative simplification shock and first measures on regulated professions)	0.2	0.3
Labour market reform	0.6	1.3
– including CICE tax credit and Responsibility Pact	0.5	1.1
– others (unemployment insurance reform, active policies)	0.1	0.2
Modification of tax system	0.1	0.4
Creation of "metropoles" (Paris and Aix-Marseille)	0.3	1.0
Reforms announced	0.4	0.7
Increase in competition in electricity and gas and reform of the regulated professions (reform a little broader than the Macron law)	0.4	0.7

Source: OCDE (2014), "France. Structural reforms: impact on growth and options for the future". October 2014.

In March, the Commission will decide whether France's 2015 Finance Act complies with the rules of the SGP. To benefit from the structural reform clause, France must then meet certain conditions:

1) The outline of the reforms needs to be clarified: at end December 2014, the Commission felt that there were still many lingering uncertainties concerning the regional reform and the content of the Macron law, uncertainties that will be resolved in the course of the parliamentary process.

2) The Ministry of Finance at Bercy must produce credible assessments of the impact of the Macron law, while the Commission will carry out its own evaluation. The Commission has already noted that the OECD's calculations will constitute the upper bound of the impact.

The evaluation of the 2015 Finance Act may result in the imposition of financial sanctions on France, unless the government decides to go for a greater fiscal adjustment. The Commission warned in late November that further steps would be needed to ensure that the 2015 budget complies with the SGP. Indeed, the Commission found that the adjustment was only 0.3 GDP point, while in June 2013 France had committed to an annual structural adjustment of 0.8 point in 2015 to bring its deficit below 3% in 2015[6].

While the Commission approves the positive effects expected from the reforms, there is a problem with the application of the "structural reform clause": the structural budgetary adjustment is still below 0.5 GDP point, which prevents the application of the new clause. France therefore still faces the threat of sanctions, despite the new doctrine.

While this analysis of the document published on January 13 shows that the Commission has given the Pact greater flexibility, it also shows that the Commission expects France to make a larger fiscal adjustment. This would be on the order of 4 billion euros (0.2 percent of French GDP) instead of the 8 billion (0.4 percent of GDP) that would have been expected back in October (the impact of a strict reading of the Pact has been analyzed here).

The Government's refrain is that it does not wish to go any further with fiscal adjustment, that this is not desirable in the current economic climate: 2015 could be a year for recovery provided that the risk of deflation is taken seriously. There is a lot of support for economic activity, including lower prices for oil and the euro, an expansionary monetary policy and the Juncker plan, even if the latter needed to go much further. However, France's fiscal policy is continuing to be a drag, and just how much so will remain uncertain until March. From now till then, with the terms of the debate clearly spelled out, everyone will need to take the risk of deflation seriously.

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[1] The Commission permits subtracting investments made under the Juncker Commission Plan from the deficit calculation; it clarifies the applicability of the "structural reform clause" and moderates the speed of convergence towards the medium term objectives (MTO) for countries in the preventive arm of the Pact based on their position in the business cycle.

[2]*Grosso modo* this means countries with a deficit of more than 3%.

[3]*Grosso modo* this means countries with a deficit of less than 3%.

[4] Which goes beyond the Macron law alone and includes the CICE tax credit and the Responsibility Pact.

[5] The OECD data were used by the Prime Minister in his October 27 letter to the Commission.

[6] In its 2014 autumn forecast, the Commission quantified the adjustment at 0.1 GDP point, but this figure is not directly comparable with the commitment of 0.8 point from June 2013.

Once the changes in national accounting standards and the unpredictable changes in certain variables are taken into account, the corrected adjustment is 0.3 GDP point. This figure is the calculation basis for the excessive deficit procedure.

What impact will fiscal policy have on French growth?

By **Eric Heyer**

The proper framework for analyzing the French economy is a large economy that is not very open, and not a small open economy: the country's economic situation has deteriorated sharply and is still far from its equilibrium position (mass unemployment, the existence of excess capacity), and its European neighbours are adopting identical approaches to fiscal policy. Under these conditions, everything indicates that the fiscal multipliers are high. The theoretical debate about the value of the multiplier and the role of agents' expectations must therefore give way to the empirical evidence: the multipliers are positive and greater than one.

Following a deep recession, the most suitable method for making a forecast of short-term activity (2 years) is to evaluate the spontaneous return of the economy (speed and magnitude) to its equilibrium or potential level, but also and above all to quantify the impact of exogenous shocks (commodity prices, economic policy, etc.) on its spontaneous trajectory.

In our last forecast, we reported that the French economy has a significant rebound potential: corresponding to spontaneous growth of nearly 4% per year in 2011 and 2012, this would allow the economy, four years after the start of the crisis, to make up the output gap built up during that period.

Two exogenous shocks will slow down the country's return to its potential level. The first involves the soaring prices of raw materials: this shock will mainly hit households and will weigh on their purchasing power and curtail their spending. This mechanism, which is also at work in the other Western countries, will cause a slowdown in their economies and hence their demand for French output. In aggregate, this purchasing power shock will cut the growth of the French economy by 1 point during the period 2011-2012. The second shock is related to fiscal policy: from 2011 onwards, the large (and small) developed countries, in the face of mounting debt and expanding government deficits, will be implementing policies of fiscal restraint. The generalization of this strategy will also put the brakes on economic growth; its impact is estimated at 2.8 percentage points of GDP during the years 2011-2012.

While there is relative agreement on evaluating purchasing power shocks, this is not the case for the impact of fiscal policy on economic activity.

What is the value of the fiscal multiplier?

Economic thought has been divided since the Great Depression over how to assess the impact of fiscal policy. Two major theoretical schools in the history of economic thought are at odds over the expected short-term impact of fiscal policy on economic activity.**1** On the one hand, the "Keynesian" school holds that an increase of one percentage point of GDP in public spending (or an equivalent decrease in taxes) should result in an increase in GDP of more than one point. This is known strictly as the Keynesian multiplier effect. On the other hand, there are a number of theoretical arguments that question the ability of fiscal policy to generate a more than proportional increase in GDP. Within this opposing school, it is then necessary to distinguish between those in favour of a positive fiscal multiplier (albeit less than one) and those in favour of a negative fiscal multiplier; in the latter case, we are speaking strictly of anti-Keynesian fiscal multipliers.

Many empirical studies have attempted to settle this theoretical debate. A review of the literature on this subject tells us that the fiscal multiplier is always positive, and that the following situations push it higher:

1. The budget policies of the partner countries are synchronized;
2. The instrument used relies more on public expenditure rather than taxation (Haavelmo, 1945);[2]
3. Monetary policy is ineffective (IMF, 2010).[3]

In a recent article, the OFCE highlighted a fourth factor, which concerns the position in the economic cycle: the multiplier is higher when the economy is at the bottom of the cycle.

What can we say about the current economic situation?

The implementation of austerity policies in all the European countries (criterion 1), focused on reducing public expenditure (criterion 2), and acting in a situation of a persistent “liquidity trap” (criterion 3) describes the context for a high multiplier.

Only an assumption that the economic crisis did not simply cause a drop in production but also may have had a strong impact on the economic potential of the euro zone economies could render the current strategy of fiscal consolidation optimal (criterion 4): based on this assumption, the rise in structural unemployment would be identical to that of actual unemployment, and the fiscal multipliers would be low in the short term and zero in the long term.

If on the other hand the growth potential of the economies did not significantly change during the crisis, then this strategy would lose its apparent effectiveness, which would confirm the relevance of the first three criteria and strengthen the impact of the fiscal consolidation.

On this crucial point, the strong stimulus imparted by economic policy renders any evaluation of the economy’s new potential path more hypothetical and makes more complex the choice of a policy to end the crisis as well as the tempo of policy implementation. In any case, the violence of the initial shock can, it seems, lift any ambiguity about the case of the developed countries: even if it were agreed that this crisis has had a powerful impact on the economy’s growth potential, this would still not cancel out the overcapacity generated by the crisis over three years.

What other scenario could lead to recovery?
A neutral fiscal policy instead of the austerity policy
Summary of the impact of a neutral fiscal policy on exchange rates and public finances

In points of deviation from the central scenario

	2011	2012
GDP	1.7	1.1
Gov’t financial balances (GDP points)	-0.6	-0.6
Unemployment rate	-0.9	-1.5

Sources : INSEE; OFCE calculations e-mod.fr.

It is also possible to enrich the analysis by approaching it this time from the perspective of unemployment rather than production: unemployment rose brutally and spectacularly from the very start of the crisis, from 7.2% in early 2008 to 9.3% in late 2010. This increase in unemployment cannot be regarded as an increase in equilibrium unemployment: during this period, there were no significant changes in labour market institutions or practices, *i.e.* the main determinants of equilibrium unemployment. In the short term equilibrium unemployment could of course have been modified by a poor sector allocation of capital and labour resources. Some reallocation may also result from reduced productivity. But in any case there is no evidence of a lasting increase in equilibrium unemployment. The situation today is indeed a situation of involuntary unemployment as compared to what we could have seen, without inflation, with the full use of the available workforce.

Under these conditions all the evidence indicates that the multipliers are high: the country's economic situation has deteriorated sharply and is still far from its equilibrium position (mass unemployment, the existence of excess capacity); monetary policy has little bite; and all the developed countries are in the same configuration and will therefore carry out the same policy.

The proper analytical framework is therefore that of a large, not very open economy, and not that of a small open economy. The theoretical debate about the value of the multiplier and the role of agents' expectations must therefore yield to the empirical evidence: the multipliers are positive and greater than one.

A simulation of a neutral budget policy indicates that the choice of fiscal consolidation proposed by the developed countries will thwart the start of a virtuous circle: without it, growth in “the Hexagon” would have been higher by 1.7 points in 2011 and 1.1 points in 2012 (Table 1). This would have allowed the unemployment rate to fall significantly (-1.5 point), eventually to 7.8% by 2012, close to the level prevailing before the crisis. The general government deficit would also have benefited from the boost in activity: it would have declined, although certainly less than in the case of the austerity policies set out (5 GDP points), reaching 5.6 GDP points in 2012 (Table 1). By raising the unemployment rate by 1.5 points compared to the baseline, *i.e.* the situation without a policy of fiscal restraint, the cost of a reduction of 0.6 GDP point in the general government deficit seems extremely high.

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1. In the long term, the effectiveness of fiscal policy vanishes. [↩]
2. Haavelmo T. (1945), “Multiplier effects of a balanced budget”, *Econometrica*, vol. 13, no. 4, October, pp. 311-318. [↩]
3. IMF (2010), “Recovery, Risk, and Rebalancing”, *World Economic Outlook*, Chapter 3, October. [↩]