

**Opinion n° HCFP-2017-2
on the general government structural balance presented in the budget settlement
bill for 2016**

12 June 2017

Under the article 23 of the constitutional bylaw n°2012-1403 of 17 December 2012 on public finance planning and governance, the High Council of public finance delivers an opinion on the compliance with multi-year targets concerning the structural balance in the budget settlement bill for 2016 (PLR). The following opinion was adopted after deliberation on 12 June 2017.

Summary

The nominal public deficit was 3.4 % of GDP in 2016, compared to 3.6 % in the public finance programming law of December 2014, which, under the 2012 organic law, has to be the reference of the High Council for the identification of possible deviations to the trajectory within the framework of the correction mechanism.

The High Council notes that the estimated structural deficit for 2016, which is 1.7 % of GDP with the assumptions of the programming law, is in line with the forecast adopted in this law (1.8 %).

It considers, however, that the 2014 programming law no longer provides a relevant framework for a proper assessment of the public finance trajectory.

The potential GDP and thus output gap¹ assumptions of this programming law, which were originally based on those of the European Commission but have not been adjusted subsequently, are now unlikely. They are increasingly distant from the estimates of international organizations which have been revised downwards several times in the meanwhile.

Moreover, as the High Council had pointed out from the outset, this programming law was setting structural adjustments objectives below the minimum laid down in the rules resulting from the Fiscal Compact.

The overestimation of the output gap in stability programs and financial frameworks of budget laws since 2015 artificially increases the cyclical component of the deficit, which mechanically reduces the structural deficit estimate. Therefore, the structural deficit, and consequently the effort to be made to restore the equilibrium of the public finances in the medium term, are

¹ Difference between observed GDP and potential GDP.

underestimated. By way of comparison, the structural deficit estimated by the European Commission for the year 2016 is 2.5 % of GDP, which is 0.8 point higher than the estimate presented by the Government.

Even if they are smaller than previously, the revisions of the economic data of the past years (in this case, 2014 and 2015) in the national accounts published by INSEE in May modify the estimates of the output gap and hence those of the structural budget balance. As the High Council has already pointed out, this instability over time in estimating the structural balance calls for the assessment of public finances to take account of other indicators that are more representative of the fiscal policy stance.

In this respect, the High Council notes that structural adjustment (the structural budget balance change) and structural effort (the part directly linked to an expenditure effort or to new measures of compulsory levies) are low in 2016 according to the current estimates. The first is estimated at 0.3 % of GDP and the second at only 0.1 %, after 0.7 % in 2015, 0.6 % in 2014 and about 1 % per year on average over the period 2011 - 2013. The year 2016 thus marked a slowdown in the efforts for the consolidation of public finances, which, as in the previous year, was exclusively on the expenditure side.

The High Council considers that, in the current situation of France's public finances, greater attention should be given to the assessment of structural effort and, more specifically, to expenditure effort.

The High Council stresses the need for the next programming law to set annual structural adjustments in line with the rules to which France has subscribed under the European Fiscal Compact.

This law must also be based on realistic output gap and potential growth assumptions, taking into account estimates made by external institutions and organizations. These assumptions of the output gap and potential growth should also be updated if necessary during the period covered by the programming law.

I- Introduction

1- Opinion's scope

Under the article 23 of the constitutional bylaw of 17 December 2012 “[...] the High Council of Public Finance gives an opinion on significant deviations, when there are some, from the trajectory observed in execution relative to the multi-year structural balance targets defined by the public finance programming law” (LPFP).

The public finance programming law in force is the last programming law voted, which is the one of 29 December 2014 for the years 2014-2019. **The organic law specifies that the structural balance must be estimated with the path of potential growth submitted in the report attached to the programming law.**

2- On the information submitted

The High Council of public finance received the referral file from the Government on 5 June 2017. This file contains the introductory article of the budget settlement bill for 2016 and in particular a summary table focusing on the actual and the structural balances for all public administrations in 2016 (appendix n°1). The referral file was supplemented with detailed answers to a questionnaire previously addressed to the relevant administrations on 17 May 2017.

Finally, the High Council organized hearings on 7 June 2017 with representatives of the Treasury General Directorate and of the Budget Directorate, as provided for by article 18 of the aforementioned organic law.

II- Remarks about the deviations from the planning

The opinion of the High Council deals mainly with the structural balance achieved in 2016. Under the terms of the organic law, the High Council is obliged to take as its reference the latest public finance programming law. In accordance with its mandate, it therefore examines the conformity of the structural balance with the 2014 public finance programming law. However, it considers this programming law to be an outdated reference.

1- A public finance trajectory formally in line with that of the LPFP

The High Council observes that the potential growth path and the estimation method for the structural balance included in the introductory article of the budget settlement bill for 2016 are consistent with the public finance programming law of December 2014 for 2014-2019. In particular, the structural balance for the year 2016 is calculated on the basis of the potential growth of the programming law, which is 1.3 % in volume².

According to the national accounts data published by the French National Institute of Statistics and Economic Studies (INSEE), the general government deficit is €75,9 billion in 2016, which represents 3,4 % of GDP, after 3,9 % in 2014 and 3,6 % in 2015. The public finance programming law anticipated a public deficit of 3,6 % of GDP in 2016.

According to the Government's estimates, the positive difference of 0.2 % of GDP with the LPFP on the 2016 balance is divided between the cyclical and structural components of the deficit.

The cyclical component of the deficit is estimated at -1.6 point in 2016 instead of -1.7 point in the LPFP. One-off and temporary measures have an impact of - 0.1 % of GDP on the public balance, as planned in the LPFP.

² This potential growth assumption for 2016 was subsequently revised upwards by 0.2 percentage point in the stability programs and budget laws from 2015 onwards.

Table 1: Differences between the budget settlement bill for 2016 (PLR) and the public finance programming law for 2014-2019 (LPFP) (in % of GDP)

| | 2014 | | | 2015 | | | 2016 | | |
|---|------------------------|-------------------------------|------------|------------------------|-------------------------------|------------|------------------------|-------------------------------|------------|
| | LPFP (Dec. 2014) | PLR 2016 (June 2017) | Gap | LPFP (Dec. 2014) | PLR 2015 (June 2017) | Écart | LPFP (Dec. 2014) | PLR 2016 (June 2017) | Gap |
| Actual balance (1) | -4.4 | -3.9 | 0.5 | -4.1 | -3.6 | 0.5 | -3.6 | -3.4 | 0.2 |
| Cyclical balance (2) | -1.9 | -1.5 | 0.4 | -2.0 | -1.5 | 0.5 | -1.7 | -1.6 | 0.1 |
| One-offs (3) | 0 | 0 | 0 | -0.1 | 0 | 0 | -0.1 | -0.1 | 0 |
| Structural balance (1)-(2)-(3) | -2.4 | -2.4 | 0.0 | -2.1 | -2.0 | 0.1 | -1.8 | -1.7 | 0/1 |

Note: Figures are rounded to the nearest tenth, so that it can lead to small differences in the results of the operations.

Source: The High Council on the basis of data from the LPFP of 29 December 2014 and from the PLR for 2016.

The structural deficit, calculated as the difference between the actual deficit and the cyclical deficit adjusted from the one-offs and short-term measures (appendix n°2), is estimated at 1.7 % of GDP in 2016, with potential growth assumption of the LPFP.

The High Council notes that the structural deficit estimated for 2016 (1.7 % of GDP) is in line with the forecast of the programming law (1.8 % of GDP).

2- The December 2014 LPFP is no longer a relevant reference for a fair assessment of the public finance trajectory

As highlighted in several of its previous opinions, the High Council considers that the 2014 programming law now constitutes an outdated reference:

- The output gap assumptions adopted in this programming law, which were originally based on those of the European Commission, have not been adjusted subsequently and are increasingly far from the estimates of international organizations (OECD, IMF, European Commission) which have been revised down several times in the interval. Potential GDP assumptions used in stability programs and budget laws, which have been revised upwards in the 2015 stability program for years as of 2016, have become unrealistic.
- For economic assumptions, the growth observed since 2013 has been close to that foreseen in the LPFP: the cumulative growth over the three years 2014-2015-2016 was slightly higher than expected (by 0.1 point). However, inflation was strongly overestimated in the LPFP.
- Finally, the programming law was not in line with France's European commitments, since it provided only for weak structural adjustments for the years 2014, 2015 and 2016, insufficient under European rules³. The High Council highlighted this non-conformity in its opinion of September 2014 on the public finance programming bill.

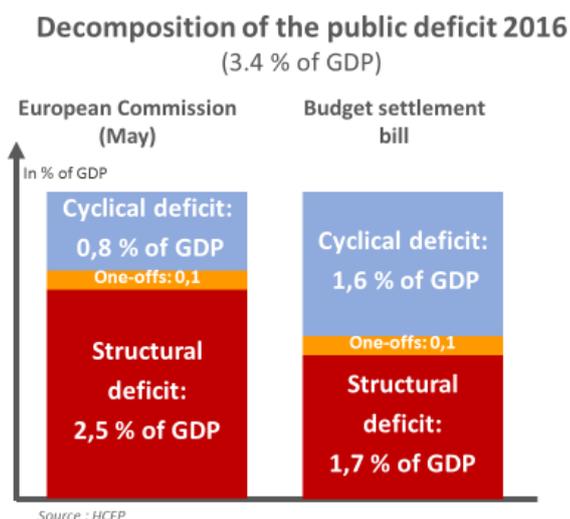
In total, the LPFP of December 2014 no longer provides a suitable framework for a fair assessment of the public finance trajectory.

The overestimation of the output gap in stability programs and budget laws since 2015 artificially increases the cyclical component of the deficit, which mechanically reduces the

³ These structural adjustments were below the minimum of 0.5 point per year defined by the European Regulation 1467/97 concerning countries subject to the excessive deficit procedure.

structural deficit estimate, which is most likely underestimated. By way of comparison, the structural deficit estimated by the European Commission is 2.5 % of GDP in 2016⁴, which is 0.8 % of GDP (one third of the estimate) more than the Government's estimate.

The effort to be made to bring public finances back to balance in the medium term is thus reduced.



III- Observations on structural adjustment and structural effort in 2016

As every year, GDP data have been revised for the years n-3 and n-2 (in this case 2014 and 2015) in the national accounts published by INSEE at the end of May 2017. **Although they were smaller than the previous year⁵ - they partially offset each other over the two years - these revisions have altered the estimates of the output gap and therefore the estimates of the structural balance for the years concerned.**

As already stressed by the High Council, **this instability over time of the structural balance estimates calls for the assessment of public finances to take account of other indicators that are more representative of the fiscal policy stance, as the structural effort.**

Structural adjustment, corresponding to the year-on-year change in the structural deficit (appendix n°3), is 0.3 % of GDP in 2016, under potential growth assumption of the LPFP.

This improvement in the structural balance is largely explained by "non-discretionary" factors, and in particular, for 0.2 point, by a spontaneous increase in compulsory levies, which is well above GDP growth in value terms. Income from social security administrations, driven by a more dynamic payroll than GDP, income tax, which benefited from a rebound in capital gains, transfer taxes and VAT contributed to this strong elasticity (1.3).

The structural effort⁶, which is the part of the improvement of the structural balance directly due to an effort in expenditure or new tax measures, and so to the public authorities action,

⁴ European Commission, Spring Economic Outlook 2017.

⁵ See opinion HCFP-2016-2 of 20 May 2016 on the budget settlement bill of 2015.

⁶ This effort is also called "discretionary" as opposed to "non-discretionary" changes in the structural balance, largely attributable to the variation in the elasticities of compulsory levies (ie differences in the spontaneous evolution of revenues and GDP growth) and the remainder to non-tax revenues.

is low in 2016 at the current estimate: calculated with the potential growth of the LPFP, it is limited to 0.1 point of GDP, after 0.7 point in 2015, 0.6 point in 2014 and about 1 point per year on average over the period 2011-2013.

This structural effort of 0.1 point is explained by a spending effort of 0.3 % of GDP partially offset by a negative impact of measures on compulsory levies (- 0.1 % of GDP).

The effort in expenditure is measured by comparing the increase in expenditure excluding tax credits (1.2 % in value) deflated by the GDP price index (0.4 % in 2016, which means an increase in volume of 0.8 %) to the potential GDP growth (estimated by the Government to 1.3 % in 2016 according to the LPFP of September 2014⁷).

On the other hand, new tax measures contributed to the reduction of structural effort by 0.1 % of GDP in 2016, with tax-reducing measures (reduction of households income tax, pact of responsibility and solidarity) higher than tax-increasing measures (increase of the contribution on electricity consumption).

Table 2: Differences in the structural adjustment between the budget settlement bill for 2016 (PLR 2016) and the public finance programming law (LPFP 2014) (% of GDP)

| | LPFP 2014 | | PLR 2016 | | Gap (PLR - LPFP) | |
|--|-----------|------|----------|------|------------------|------|
| | 2015 | 2016 | 2015 | 2016 | 2015 | 2016 |
| Structural balance | -2.1 | -1.8 | -2.0 | -1.7 | 0.2 | 0.3 |
| Structural adjustment (a+b+c) | 0.4 | 0.3 | 0.4 | 0.3 | 0.0 | 0.0 |
| Structural effort (a) | 0.6 | 0.2 | 0.7 | 0.1 | 0.1 | -0.1 |
| <i>New tax measures</i> | 0.1 | -0.1 | -0.1 | -0.1 | -0.2 | 0.0 |
| <i>Effort in expenditure</i> | 0.5 | 0.4 | 0.8 | 0.3 | 0.3 | -0.1 |
| Non-discretionary component (b) | -0.1 | 0.0 | -0.2 | 0.1 | -0.1 | 0.1 |
| <i>Revenue excluding compulsory levies</i> | 0.0 | 0.0 | 0.0 | -0.1 | 0.0 | -0.1 |
| <i>Effects of tax elasticities</i> | -0.1 | 0.0 | -0.1 | 0.2 | 0.0 | 0.2 |
| Processing of tax credits ⁸ (c) | -0.1 | 0.0 | -0.1 | 0.1 | 0.0 | 0.1 |

Note: Figures are rounded to the nearest tenth, so that it can lead to small differences in the results of the operations.

Source: High Council on the basis of data from the LPFP of 29 December 2014 and from the PLR for 2016.

The effects of other items offset each other in terms of structural adjustment (- 0.1 point for non-tax revenues, + 0.1 point on the treatment of tax credits).

The High Council notes that structural adjustment and structural effort are weak in 2016. The year 2016 thus marks a slowdown in the effort for the consolidation of public finances, which, however, is a purely spending effort.

IV- Guidelines for the development of the next programming law

⁷ As public expenditure represents more than 50 % of GDP, the effort in terms of expenditure is close to half of the gap between the rate of growth in volume of actual and potential GDP.

⁸ The cost, in national accounting, of refundable tax credits (CICE, CIR) corresponds to an obligation acquired, whereas their cost measured in terms of tax levies effort corresponds to the budgetary amount recovered or assigned. A term measuring the gap between these two measures is given in the decomposition of the structural adjustment. During the implementation of the CICE, this gap is negative because the obligation acquired is higher than the budgetary cost.

In the light of the recommendations already made in its previous opinions and with a view to the next programming law:

- 1. The High Council considers that the assessment of the state of public finances must take into account other indicators than the level of the structural balance or its distance from the trajectory of the programming law. Among these indicators which would better reflect the fiscal policy stance, greater emphasis must be given to structural effort and, in particular, to the structural effort in terms of expenditure in view of France's public finances.**
- 2. It stresses the need for the new programming law to establish structural adjustments in line with the rules to which France has subscribed under the European Fiscal Compact.**
- 3. As regards with the structural balance trajectory, the assumptions of output gap and potential growth presented in the programming law must be established on a realistic basis, taking into account estimates made by external institutions and bodies, and those assumptions should be able to be updated as necessary during the period covered by the programming law.**

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This opinion has been published in the *Official Journal* of the French Republic and attached to the budget settlement bill for 2016.

ANNEX: method for estimating the structural balance

To assess the public finance trajectory, it is customary to consider the structural budget balance, which corresponds to the **public balance adjusted for direct effects of the economic cycle as well as exceptional events**. The public balance is thus divided into two components:

- A **cyclical component** that represents the impact of the economic cycle on the expenditure and revenue of the public administrations;
- A **structural component** corresponding to what the public balance would be if domestic production was at its potential level.

The identification of cyclical and structural components of the public deficit is based fundamentally on the estimation of potential GDP. Specifically, the identification takes place by first calculating the cyclical components of the public revenue and expenditure:

- **On the revenue side**, only mandatory contributions are assumed to be cyclical. The cyclical level of the income tax, corporate income tax, social security contributions and other mandatory contributions is calculated separately based on the observed levels, the estimated output gap and the elasticity of each tax category;
- **On the expenditure side**, only the unemployment compensation expenses are considered dependent on economic conditions. The cyclical share is estimated, as for revenue, based on its elasticity in relation to the output gap and the amount recognized each year.

The calculation of the cyclical component of the balance and, by difference with the actual general government balance, of the structural balance then results directly from these estimates. A simplified method helps to approach the cyclical balance. Given the fact that the mandatory contributions and expenses sensitive to the economic situation account for about half of GDP and that their average elasticity is close to one, the cyclical balance corresponds, in the case of France, to just over half the output gap.

A final correction is made to the structural balance in order to exclude certain events or actions that, because of their exceptional nature, have no lasting impact on the public balance. **However, there is no comprehensive definition of one-off and temporary measures and their identification is partly based on interpretation.**