Haut Conseil des Finances Publiques

Opinion n° HCFP - 2017 - 3
On the public finance programming bill
for the years 2018 to 2022

September 24, 2017

Main conclusions

The High Council notes that the output gap (between actual and potential GDP) estimate has been substantially revised downwards, by comparison with previous financing laws. The new estimate is in the lower range of international organizations' estimates. The High Council considers it more realistic. This revision leads to higher structural deficit estimates (-2.5 % rather than -1.5 % of GDP for 2016). It is consistent with remarks the High Council made in the past and reveals the need for a greater effort to achieve a balanced budget in the medium term.

The Government's potential growth scenario is close to the average of available estimates. The High Council considers it a reasonable basis for medium term public finance programming.

The Government's macroeconomic scenario anticipates the closure of the output gap by 2020 and an increasingly positive output gap beyond. The High Council regards the closure of the output gap within the frame of the bill as plausible in the absence of a new crisis. However, it considers the assumption of a positive output gap at the end of the period rather optimistic. It notices that this assumption leads to a lower public deficit at the end of the period and to a more favorable path of public debt.

The Government's bill respects the recommendation made by the European commission to France to bring its public deficit below 3 % of GDP in 2017. France could therefore exit the ongoing excessive deficit procedure in 2018 and enter the preventive arm of the Stability and Growth Pact. Under its rules, structural deficit must be reduced in order to reach the medium term objective (set to -0.4 % of GDP in the programming bill).

In this respect, the High Council emphasizes that the planned path moves away from France's European commitments, its annual structural adjustment being lower than the one provided by article 5 of the European Regulation n°1466/97. The achievement of the medium term objective (MTO) is therefore deferred beyond the term of the programming bill.

Given the planned reductions in compulsory levies, the bill implies the respect of a demanding public expenditure path. Considering the high level of structural deficit, the High Council emphasizes the need to respect the spending objectives, even in the event of better than expected revenues.

Introductory remarks

1- On the opinion's scope

Under article 34 of the Constitution, public finance programming laws define the multi-year targets for public finances. Under the 2012 constitutional bylaw, programming laws set the medium term objective (MTO) for the general government structural balance – mentioned in article 3 of the Treaty on Stability, Coordination and Governance (TSCG). They determine the path of the general government structural and actual balances to the MTO.

Once voted by Parliament and published, the structural balance targets provided by the public finance programming law for the years 2018 to 2022 will replace those of the public finance programming law n° 2014-1653 for the years 2014 to 2019 of 29 December 2014.

Henceforth the High Council will refer to this new path to assess the consistency of the budget and social security financing bills with the multi-year targets and to review the execution results under the correction mechanism.

Under article 13 of the constitutional bylaw of December 2012, the High Council gives an opinion on:

- the potential gross domestic product estimate on which the programming bill is based;
- the macroeconomic assumptions attached to the programming bill;
- the consistency of the targets with the MTO and with France's European commitments.

2- On the information submitted

The Government referred to the High council of public finance on 15 September 2017, its macroeconomic forecasts, its potential GDP estimate and complementary information in order to assess the consistency of the programming bill's public finance targets with France's European commitments. The file was supplemented with detailed answers to questions addressed in advance by the High Council to the relevant administrations. Further information was transmitted up to September 20, 2017. An amended referral file was submitted to the High Council on September 23, 2017.

The High Council notes that the entire programming bill and its enclosed report were attached to the referral file. This was of great help for its work and constitutes a good practice to be extended to all public finance bills.

3- On the methodology used by the High Council

To assess the realism of the macroeconomic forecasts transmitted by the Government, the High Council considered the last available statistics and information provided by the Government.

The High Council's opinion is based on the last economic forecasts produced by several institutions, including international organizations – the European Commission, the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) – and national ones – the French National Institute of Statistics and Economic Studies (INSEE), the Banque de France and forecasting institutes such as COE-Rexecode or the French Economic Observatory (OFCE).

As permitted by article 18 of the constitutional bylaw, the High Council held hearings of the relevant administrations' representatives –Treasury, budget and social security departments. It also held hearings of representatives of the European Commission, the OECD, the Banque de France, the CEPII, COE-Rexecode and the OFCE.

The High Council heard the European commissioner for economic and financial affairs, taxation and customs.

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I- Introductory remarks on potential GDP and its use in public finance programming

1- The concepts

The potential gross domestic product (GDP), its growth (known as potential growth), the output gap and the general government structural balance are now important aggregates for budgetary governance. They are included in the definition of France's European commitments.

Potential GDP is usually defined as the "sustainable" output, i.e. the quantity which can be produced without having positive or negative impacts on inflation. It is mainly a supply side concept. Its level depends on the actual capital stock, on the available labor force and on how efficiently these two factors are combined.

The output gap is the difference between actual output, measured by GDP, and potential GDP. It reflects the country's rebound capacity when negative and a slowdown prospect when positive. It makes it possible to evaluate the cyclical component of the public balance and thereby measure the structural balance.

2- Their weaknesses

Output gap and potential growth are not statistical or accounting data but the results of estimations. These estimations entail a lot of uncertainty. The Government's approach, as well as the approach of most of the international organizations, is based on a production function, where potential growth is calculated from the trajectories of labor, capital and total-factor productivity (TFP). Potential growth estimates require assumptions about how to measure these production factors and how to assess their trend. Estimations are heavily sensitive to statistical methods and to the data used. In fact, there are important *ex post* revisions on output gap estimates (annex n°1).

Uncertainties on the output gap affect by construction the structural balance estimate, which also depends on the tax revenues' elasticity to growth.

The scale of the financial crisis and the difficulty to assess its consequences on the economy induce a particular prudence when considering the output gap.

3- Their usefulness for public finance programming

However uncertain and fragile the estimation of its level may be, the measure of the structural balance is essential to assess the situation of public finances and the direction of budget policies. It enables to distinguish the cyclical component from the structural part of the public balance, and therefore helps assessing the structural improvement of public finances. It shows the size of the effort needed to achieve a balanced budget in the medium term.

In several recent opinions, the High Council, noticing that structural balance estimates are unstable over time and sensitive to revisions of GDP, favored the introduction of other, more significant, indicators for the analysis: the variation of the structural balance (structural adjustment), or, better, the structural effort (the sum of new revenue measures and expenditure restraints). Since it involves the potential growth, but not the output gap level, the structural effort is less affected by revisions than the structural balance.

II. Remarks on the potential GDP estimate

1- The Government's scenario

"The Government's new scenario is a -1.5 % output gap in 2016 (rather than -3.1 % under the assumptions of the April 2017 Stability Program)".

In its referral file, the Government states that: *"This forecast is based on a 1.25 % potential growth from 2017 to 2020, 1.3 % in 2021 and 1.35 % in 2022. This estimate is close to that of the European Commission and is based on a lower trend of productivity than before the crisis, notably due to a global slowdown in the impact of technical progress.*

The potential growth would pick up by 2022 thanks to the positive impact of structural reforms implemented during the presidential term […].

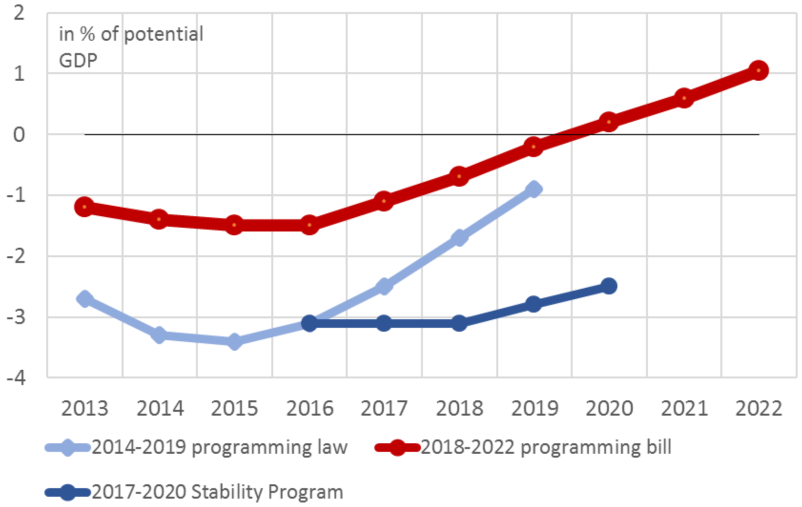
The medium-term scenario is a gradual improvement in the output gap, from -1.5 % in 2016 to +1.1 % in 2022. »

2- The High Council's assessment

<u>*The output gap at the beginning of the period*</u>

The Government's estimate for the 2016 output gap is significantly reduced from the one of the April 2017 Stability Program (- 1.5 % of GDP from – 3.1 %).

Output gap (in % of potential GDP)



Sources: 2014-2019 programming law, 2017-2020 Stability Program, 2018-2022 programming bill

This large revision downwards is consistent with the previous remarks of the High Council, stating that the output gap estimate was overestimated in public finance laws and Stability Programs over the last years.

The Government's new estimate for 2016 (-1.5 %) is close to that published by the European commission in May 2017 (-1.3 %). It is lower – in absolute terms – than the IMF's estimate (-2.0 %) and the OECD's estimate (-2.3 %). Among national institutions, the OFCE has a higher estimate (-2.7 %). While the previous estimate was clearly disproportionate, the Government's new estimate is in the lower range of available estimates.

Taking into account a lower output gap reduces the cyclical component of the public deficit and therefore increases the structural deficit for the year 2016. A higher structural deficit estimate reveals the need for a greater budgetary effort than stated in the previous public finance bills, as the High Council highlighted several times in the past.

The potential growth

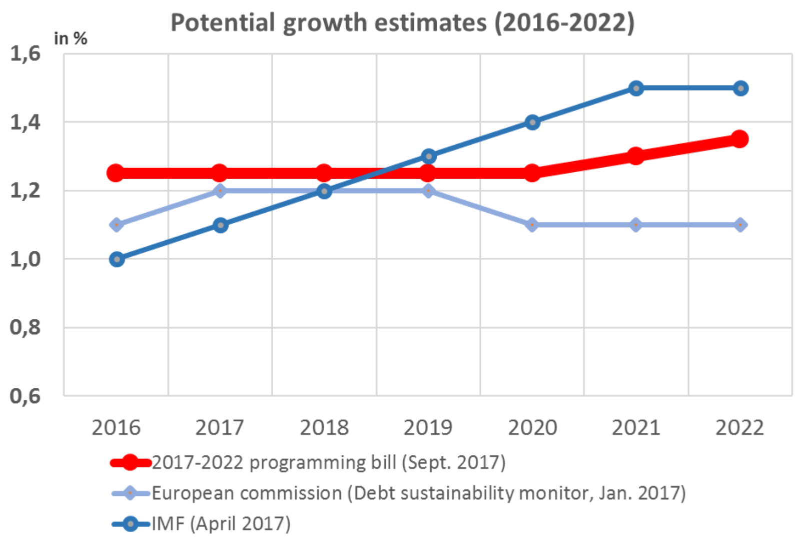
The potential growth assumptions have been revised downwards for the years 2017-2020, in comparison to the April 2017 Stability Program (1.25 % each year rather than rates between 1.3% and 1.5% in the Stability Program).

Potential growth forecasts by international organizations

	2016	2017	2018	2019	2020	2021	2022
Programming bill 2018-2022 (September 2017)	**1.25**	**1.25**	**1.25**	**1.25**	**1,25**	**1.30**	**1.35**
April 2017 Stability Program	1.5	1.5	1.4	1.3	1.4	-	-
Programming law 2014-2019 (December 2014)	1.3	1.3	1.2	1.1			
European commission (2017 Winter forecasts)	1.1	1.2	1.2	1.2	1.1	1.1	1.1
IMF (April 2017)	1.0	1.1	1.2	1.3	1.4	1.5	1.5
OECD (June 2017)	1.3	1.2	1.2	-	-	-	-

Source: HCFP based on forecasts by the OECD, the IMF, the European commission, the December 2014 Programming law, the April 2017 Stability Program and the September 2017 Programming bill.

Regarding the level, the Government's potential growth estimates are close to those of the OECD and are between the ones of the European commission and the IMF from 2019 on. Concerning the trend, the Government expects a slight increase at the end of the period, whereas the European commission forecasts a drop. The IMF anticipates a steady increase over the whole period. Therefore, the Government's scenario is an intermediate scenario.



The High Council notes that the output gap (between actual and potential GDP) estimate has been substantially revised downwards, by comparison with previous budget bills and stability programs. The new estimate is in the lower range of international organizations' estimates. The High Council considers it more realistic. This revision leads to higher structural deficit estimates (-2.5 % rather than -1.5 % of GDP for 2016). It is

consistent with remarks the High Council made in the past and reveals the need for a greater effort to achieve a balanced budget in the medium term.

The Government's potential growth scenario is close to the average of available estimates. The High Council considers it a reasonable basis for medium term public finance programming.

III. Remarks on the macroeconomic forecasts

The High Council's remarks on the years 2017 and 2018 are presented in the opinion n° HCFP - 2017 - 4 on the budget bill and the social security financing bill for the year 2018.

1- The Government's scenario

Main assumptions of the macroeconomic scenario 2017-2022

	2017	2018	2019	2020	2021	2022
GDP growth (wda[1])	1.7	1.7	1.7	1.7	1.7	1.8
Inflation	1.0	1.1	1.1	1.4	1 ¾	1 ¾

Source: Programming bill (September 2017)

On the word of the Government: *"Growth would increase significantly in 2017 to +1.7 % and then stabilize in 2018. […] Activity would stay high until 2022, which would allow the gradual improvement of the output gap. […] Growth would be +1.7 % from 2019 to 2021 and reach 1.8 % in 2022. […] The medium-term scenario is a gradual improvement of the output gap, from -1.5 % in 2016 to +1.1 % in 2022."*

"Inflation would increase gradually under the assumption that the ECB is credible in anchoring inflation anticipations towards its medium-term objective. In France, inflation would converge to 1.75 % in 2021 and 2022."

2- The High Council's assessment

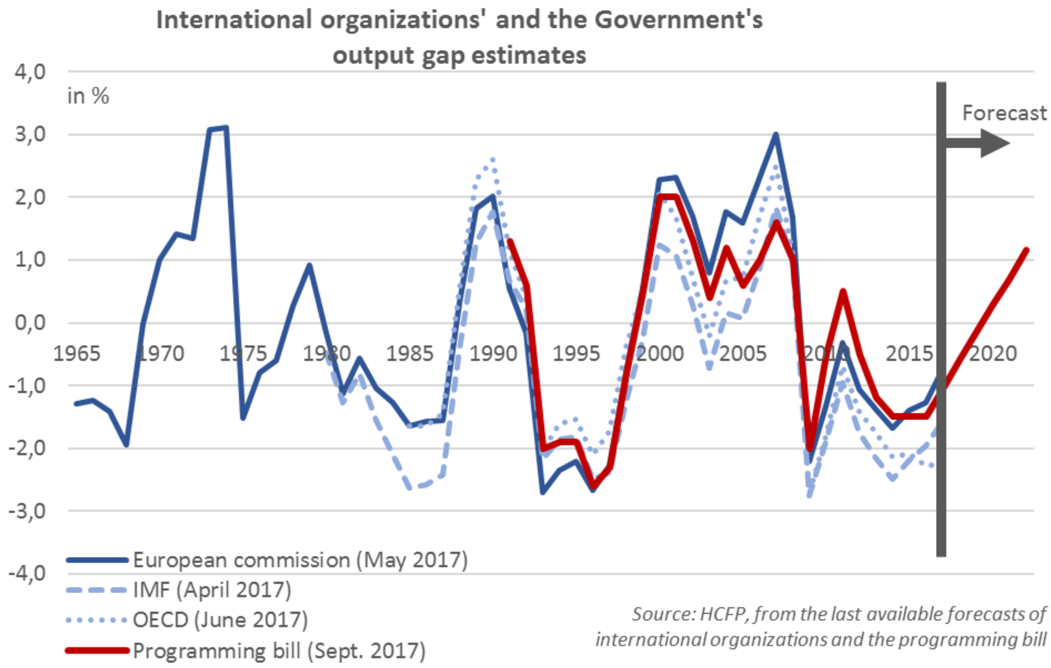
The Government's scenario assumes quite steady GDP growth rates over the period, around 1.7 %. In comparison with the medium-term forecasts presented last April in the 2017-2020 Stability Program, the growth forecasts are slightly higher for the years 2017 (1.7 % instead of 1.5 %), 2018 (1.7 % instead of 1.5 %) and 2019 (1.7 % instead of 1.6 %). It is unchanged for 2020 (1.7 %).

The assumption of an actual growth greater than potential growth is consistent with an initially negative output gap.

It leads to the closure of the output gap by 2020, which does not call for any remarks. Beyond, it leads to an increasingly positive output gap. Such an assumption may appear optimistic, since potential growth determines the average actual growth on the medium term.

This assumption is not neutral on the path of public finances. Even though it does not affect the structural balance, it leads to a lower public deficit at the end of the period and to a more favorable path of public debt.

[1] Working day-adjusted.



Inflation forecasts (1.1 % in 2017 and 1.0 % in 2018) have been slightly revised downwards by comparison with the Stability Program for the beginning of the period. Inflation would then increase gradually and reach 1 ¾ % in 2021 and 2022.

The High Council notes that these forecasts are along other available forecasts. Such a gradual increase in inflation can be justified by the expected decrease of the output gap and the determination of the European Central Bank to reach its objective. However, it is subject to uncertainties, given the persistent weakness of inflation in all developed countries since the crisis and despite the determined action of central banks.

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The High Council notes that the Government's macroeconomic scenario anticipates the closure of the output gap by 2020 and an increasingly positive output gap beyond. Given the current trend, growth should be greater than its potential in 2017 and 2018, for the first time since 2011. The output gap is therefore narrowing. Its closure within the frame of the bill is plausible in the absence of a new crisis.

Yet, the assumption of a positive output gap at the end of the period is rather optimistic. Even though such a growth scenario may happen, it entails more uncertainty. While neutral on the path of the structural balance, this growth scenario leads to a lower public deficit at the end of the period and to a more favorable path of public debt.

IV. Remarks on the public finance targets

The 2012 constitutional bylaw provides that *"the High Council [assesses] the consistency of the presented targets regarding the medium term objective (MTO) and France's European commitments »*.

European rules

The corrective arm of the Stability and Growth Pact

The general government public deficit shall be below 3 % of GDP. Public debt shall be lower than 60 % of GDP or sufficiently diminishing.

If the public deficit is above the 3 % threshold, which is France's case since 2009, an excessive deficit procedure is launched under the corrective arm of the Stability and Growth Pact. The Member State shall take effective action; if not sanctions can be triggered.

With respect to the Council's recommendation of March 5, 2015, France shall correct its excessive deficit by 2017. In order to exit the excessive deficit procedure, two conditions must be met: the public deficit in 2017, as established by outturn data, must be below 3 % of GDP, and the Commission must regard the respect of this threshold as durable.

The preventive arm of the Pact

Once the deficit is below the 3% threshold, the Member State enters the preventive arm of the Stability and Growth Pact. The structural deficit shall then improve rapidly towards the medium term objective, the minimum structural adjustment depending on the macroeconomic conditions and the debt level.

Regulation 1466/97 provides that the structural adjustment for a country which has not reached its MTO and whose debt level is above 60 % of GDP shall be greater than 0.5 % of GDP per year[2]. The Regulation suggests an even greater adjustment in economic good times.

Furthermore, the TSCG states that Member States "shall ensure rapid convergence towards the MTO".

1- The Government's scenario

In the programming bill for the years 2018 - 2022, the Government anticipates a -2.9 % of GDP nominal deficit in 2017 and a reduction to -2.6 % in 2018. The deficit would temporarily reach -3.0 % in 2019 because of the CICE's transformation into a social contribution cut[3], and then decrease again from 2020 on, in order to reach a quasi-balance in 2022 (-0.2 %).

Nominal and structural balance path from 2012 to 2022

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Nominal balance (in % of GDP)	-4.8	-4.0	-3.9	-3.6	-3.4	-2.9	-2.6	-3.0	-1.5	-0.9	-0.2
Cyclical component (in % of GDP)	-0.3	-0.7	-0.8	-0.9	-0.8	-0.6	-0.4	-0.1	0.1	0.3	0.6
One-off and temporary measures (in % of potential GDP)	-0.1	0.0	0.0	0.0	-0.1	-0.1	-0.1	-1.0	-0.1	-0.1	0.0
Structural balance (in % of potential GDP)	-4.4	-3.3	-3.1	-2.7	-2.5	-2.2	-2.1	-1.8	-1.6	-1.2	-0.8
Structural adjustment	*1.0*	*1.1*	*0.2*	*0.4*	*0.2*	*0.2*	*0.1*	*0.3*	*0.3*	*0.4*	*0.4*

Source: programming bill for 2018-2022

[2] Article 5 of Regulation 1466/97: "For Member States faced with a debt level exceeding 60 % of GDP or with pronounced risks of overall debt sustainability, the Council and the Commission shall examine whether the annual improvement of the cyclically-adjusted budget balance, net of one-off and other temporary measures is higher than 0,5 % of GDP. The Council and the Commission shall take into account whether a higher adjustment effort is made in economic good times, whereas the effort might be more limited in economic bad times."

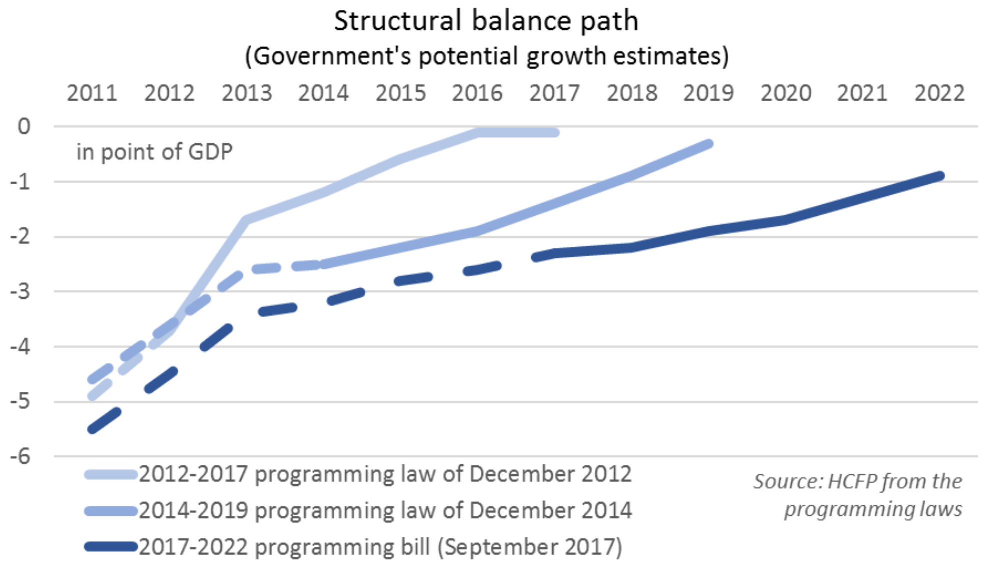
[3] The Government regards this measure as temporary; it would therefore not affect the structural balance path.

2- The consistency of the public finance targets with France's European commitments

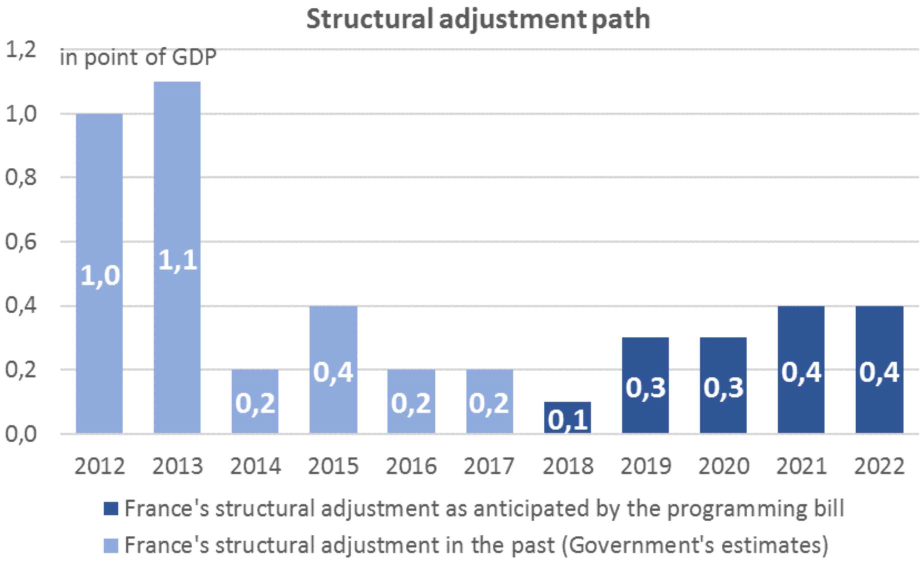
The structural deficit, estimated by the Government at 2.5 % of GDP in 2016, would decrease each year of the programming period. However its decrease would be small at the beginning of the period (0.1 point in 2018 after 0.2 point in 2017), and then higher from 2019 to 2022 (0.3 then 0.4 point). The structural deficit would therefore be brought to 0.8 % of GDP in 2022, from 2.2 % of GDP in 2017.

The structural balance medium term objective (MTO), set by the programming bill (-0.4 % of GDP, unchanged), would not be reached within the timeframe of the bill. At best, this would be achieved in 2023. In this regard, the High council notes that the bill moves away from Article 3 of the TSCG, under which Member States "shall ensure rapid convergence towards their respective MTO".

Structural balance trajectories have been rapidly and regularly revised in the public finance bills and Stability Programs. Consequently, the achievement of the MTO has been deferred several times.



The new deferral is partly due to the upward revision of the structural deficit – as a result of the new output gap estimate – and partly to an insufficient structural adjustment over the period. The structural deficit for 2016 is one percentage point higher than in previous estimates. Concerning the presented structural adjustment, it is only 0.3 point of GDP high per year on average between 2018 and 2022 (see figure below). It is even down to 0.1 point in 2018.



Source: HCFP, from the Government's and the programming bill's estimates

Being lower than 0.5 point of GDP per year, the planned structural deficit adjustment from 2018 to 2022 does not comply with Article 5 of European Regulation 1466/97.

When they assess the budgetary planning of a Member State, the Commission and the Council may take into account major structural reforms or unusual events outside of the Government's control to allow temporary deviations from its structural adjustment path to the structural balance medium term objective (MTO).

Flexibility clauses in European rules

In February 2016, the ECOFIN Council adopted flexibility clauses for the Stability and Growth Pact. These flexibility clauses have three components: unfavorable macroeconomic conditions, specific investment spending and structural reforms.

Regarding structural reforms, the flexibility clause requires in theory that the Member State already is, and stays after the measure, under the preventive arm of the Pact, but also that its public balance is far enough from the 3 % of GDP threshold to ensure it will not cross this threshold. The achievement of the MTO shall also be planned within 4 years after the beginning of the structural reforms[4].

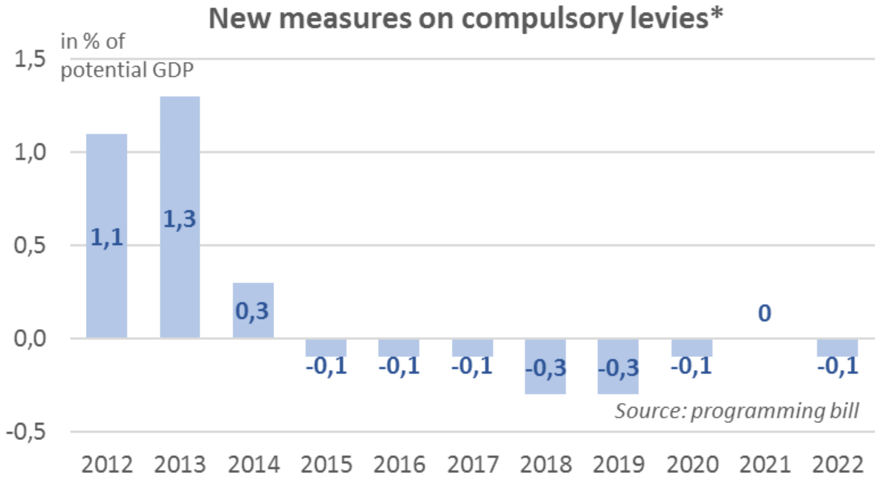
3- The plausibility of the structural balance path

As for the macroeconomic assumptions, the High Council's remarks on the years 2017 and 2018 are presented in the opinion n° HCFP - 2017 - 4 on the budget bill and the social security financing bill for the year 2018.

The planned structural adjustment of about 0.3 point per year on average over the period 2018-2022 represents a slow improvement of public finances. However, given the planned tax

[4] "When defining the adjustment path to the medium-term budgetary objective for Member States that have not yet reached this objective, […] provided that an appropriate safety margin with respect to the deficit reference value is preserved and that the budgetary position is expected to return to the medium-term budgetary objective within the programme period, the Council and the Commission shall take into account the implementation of major structural reforms which have direct long-term positive budgetary effects, including by raising potential sustainable growth, and therefore a verifiable impact on the long-term sustainability of public finances." (Regulation 1466/97, Article 5.1 c). The "appropriate safety margin" has been defined in a communication of the European Council on 30 November 2015: the structural balance on the starting year must not be further than 1.5 % from the MTO (this means a structural deficit below 1.9 % for France).

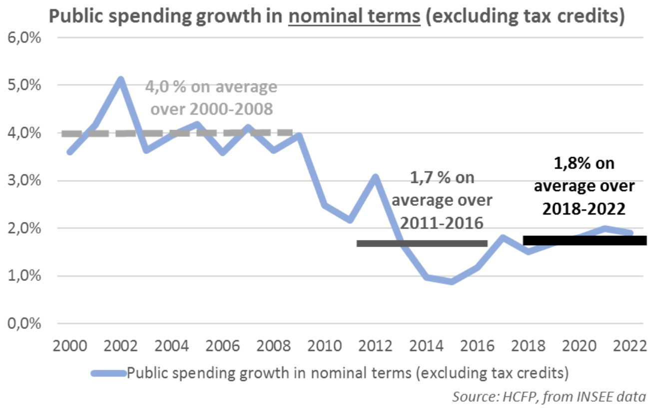
cuts in the coming years, this path requires expenditure restraints (excluding tax credits), about 0.5 point on average over the period 2018-2022 – more than what has been achieved since 2014.

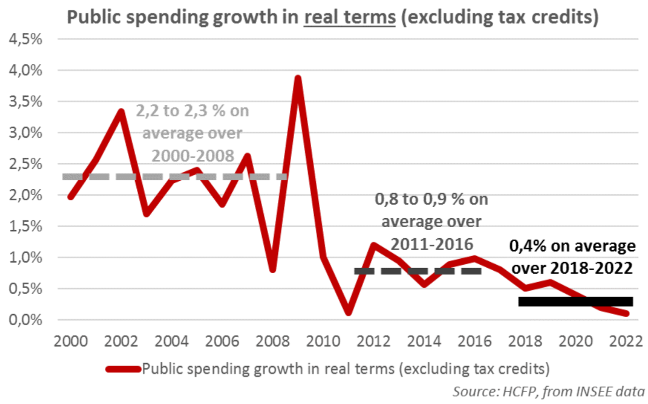


*: excluding in 2019 the impact of the CICE's transformation into a social contribution cut.

The nominal public expenditure, as planned in the programming bill, would grow 1.8 % each year over the period 2018-2022, which is close to its average growth from 2011 to 2016 (1.7 % per year) and more than from 2014 to 2016 (about 1 % per year). Nevertheless, since an increase in inflation is anticipated, the real growth would be lower than in the past (0.4 % on average from 2018 to 2022 vs. 0.8 to 0.9 % from 2011 to 2016, see figure below).

The upward trend of some expenses in the coming years (interest expenditure[5], national defense...) will impose a bigger effort on other spending.





France has, after Spain, the highest public deficit in the euro zone (annex 2). These two countries are the only ones with an ongoing excessive deficit procedure in 2017. For France, cumulative substantial public deficits have led to a debt to GDP ratio increase of about 15 points between 2010 and 2016.

The efforts planned in the programming bill must therefore be implemented rigorously in order to allow the structural balance to converge to the medium term objective and the debt to GDP ratio to start decreasing in a durable manner.

As examples abroad have showed, these efforts are not out of reach. However, they will require determined action in order to curb public spending.

[5] The Government's scenario is based on the assumption of an interest rate increase over the period, up to 4 % in 2022. The general government interest expenditure would grow by 0.4 point of GDP between 2018 and 2022.

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The Government's bill respects the recommendation made by the European Council to France to bring its public deficit below 3 % of GDP in 2017. France could therefore exit the ongoing excessive deficit procedure in 2018 and enter the preventive arm of the Stability and Growth Pact. Under its rules, structural deficit must be reduced in order to reach the medium term objective (set to -0.4 % of GDP in the programming bill).

In this respect, the High Council emphasizes that the planned path moves away from France's European commitments, its annual structural adjustment being lower than the one provided by article 5 of the European Regulation n°1466/97. The achievement of the medium term objective (MTO) is therefore deferred beyond the term of the programming bill.

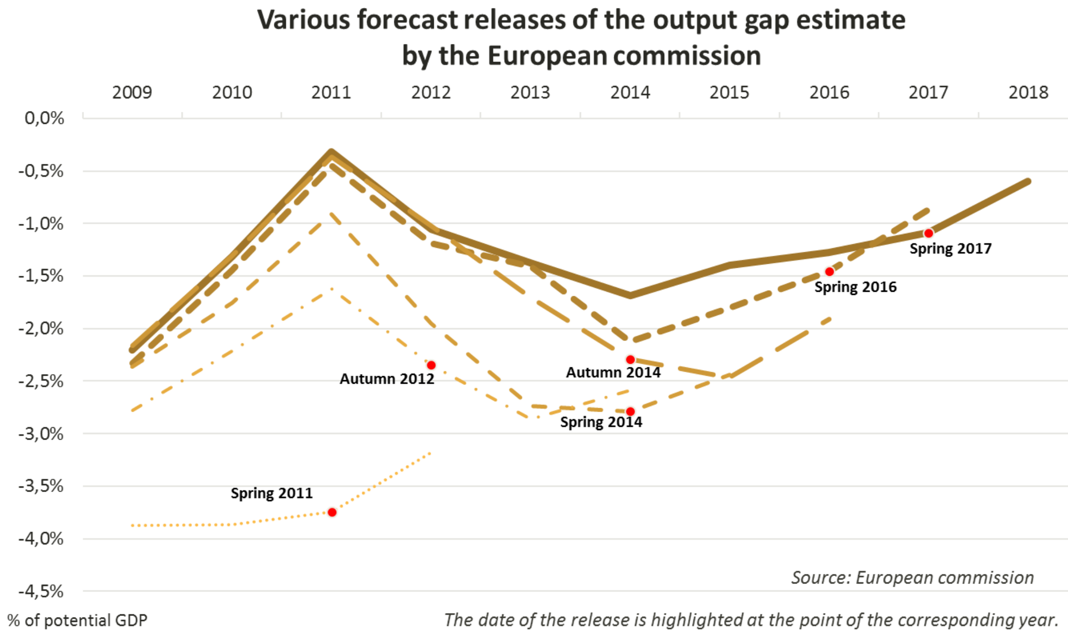
Given the planned reductions in compulsory levies, the bill implies the respect of a demanding public expenditure path. Considering the high level of structural deficit, the High Council emphasizes the need to respect the spending objectives, even in the event of better than expected revenues.

This opinion has been published in the *Official Journal* of the French Republic and attached to the public finance programming bill for the years 2018 to 2022 transmitted by the Government to the Parliament.

Annex 1: Analysis of the output gap estimate revisions in the European Commission forecasts

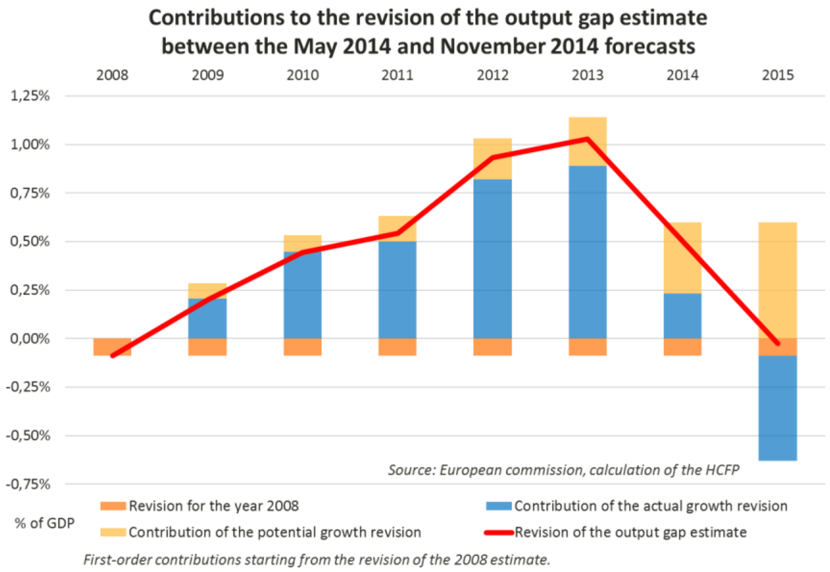
International organizations use different methods in order to estimate potential growth and output gap. Their estimates diverge significantly: the European commission's estimate for France's 2016 output gap is -1.3 % of GDP, whereas the IMF's estimate is -2.0 % and the OECD's -2.3 %. In France, the OFCE's estimate is -2.7 %. Until April 2017, the Government's estimate was about -3 %, last updated in April 2015.

With a constant methodology, revisions can occur for several reasons: revisions on actual GDP growth data and revisions on potential growth estimates[6]. These revisions can prove substantial and lead to reconsider the economy's cyclical position *ex post*.

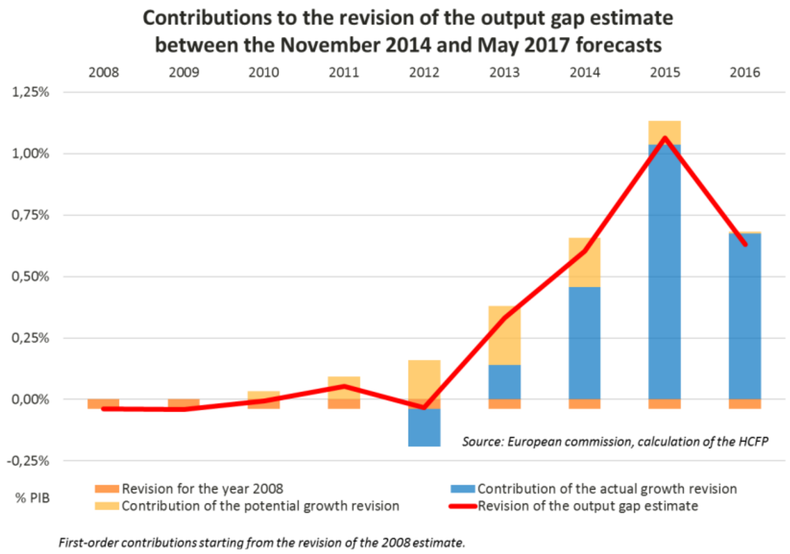


An analysis of the Commission's various forecast releases shows how actual and potential growth contribute to revisions of the output gap estimate. Between the Spring and Autumn 2014 forecasts, the 2013 output gap estimate has been revised by about 1 point of GDP (see figure below). This is mainly due to revisions on the previous years' actual GDP growth figures (as published by the INSEE, following the May 2014 rebasing).

[6] See Trésor-Éco n° 120, « Un budget pour la zone euro », October 2013, https://www.tresor.economie.gouv.fr/Ressources/File/391818



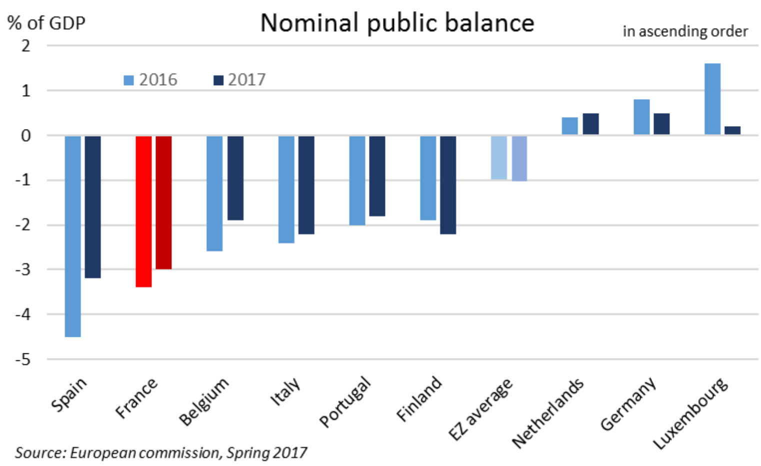
The difference between the Autumn 2014 and the Spring 2017 forecasts' output gap estimate for the same year 2013 is smaller, about 0.3 point of GDP. Almost 2/3 of this revision is due to changes in potential growth estimates.



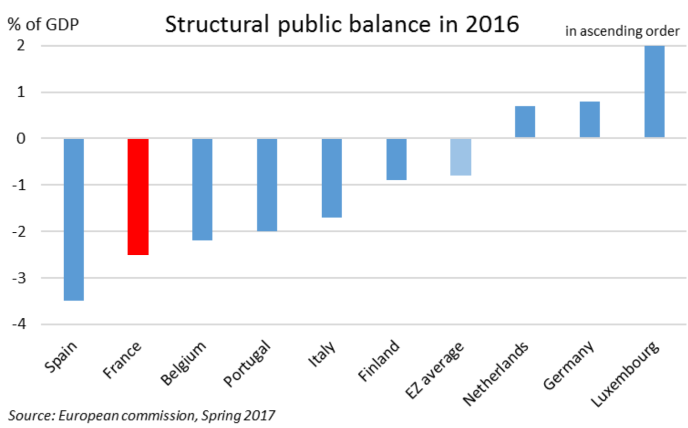
On a longer period, even larger revisions have been observed on the output gap estimate, eventually changing its sign. The 2006 output gap estimate in Autumn 2006 was -0.8 %, though it is estimated at +2.8 % today.

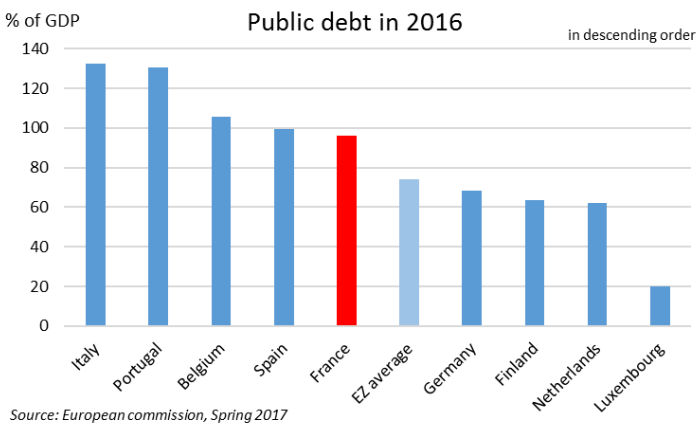
Annex 2: France's public finances compared with the euro zone

Given its public deficit, above 3 % of GDP, France is currently involved in an excessive deficit procedure, launched by the European Union in 2009. Under the common budgetary rules, the "corrective arm" applies. Today, only Spain and France are still in an ongoing excessive deficit procedure.



Beyond its nominal deficit, France's public finances appear to be less sound than the euro zone average, especially in terms of structural deficit and debt level.





Annex 3: estimating the general government structural balance

The structural balance estimate

To assess the public finance path, the structural budget balance is usually considered. The structural balance is the **public balance adjusted for the direct impact of the economic cycle and exceptional events**. The public balance is thus divided into two components:

- A **cyclical component,** which reflects the impact of the economic cycle on public administrations' expenditure and revenue;
- A **structural component,** being what the public balance would be if domestic production were at its potential level.

The calculation of the cyclical and structural components of the public balance is based on the potential GDP estimate. Potential GDP is the "sustainable" output, i.e. the quantity that can be produced without having positive or negative impacts on inflation. The cyclical component of the public balance results from the cyclical variations in public revenue and expenditure, considered as follows:

- **On the revenue side**, only compulsory levies are assumed to be cyclical. The cyclical parts of the income tax, corporate income tax, social security contributions and other mandatory contributions are calculated separately based on the observed levels, the estimated output gap and the elasticity of each tax category to GDP growth[7];
- **On the expenditure side**, only the unemployment compensation expenses are considered dependent on economic conditions[8]. Their cyclical share is estimated, as for revenue, based on their elasticity to the output gap and the amounts observed.

The structural balance is calculated as the difference between the nominal public balance and the cyclical component estimate. Given the fact that compulsory levies and cyclical expenses account for about half of GDP and that their average elasticity is close to one, the cyclical component of the public balance is equal to just over half the output gap (for France). **A final correction is made to the structural balance in order to exclude certain events or actions** that have no lasting impact on the public balance. **However, there is no comprehensive definition of one-off and temporary measures and their assessment is partly based on interpretation.**

The components of the structural adjustment

The variation of the structural balance is known as "structural adjustment". A positive structural adjustment reflects a budgetary policy directed towards the medium term objective (-0.4 % for France as set by the programming law). Conversely, a negative structural adjustment reflects an expansionist budgetary policy, increasing the structural deficit.

In order to assess more sensibly the budgetary policy, the **structural adjustment is divided into two components**.

- **The structural effort, which measures the discretionary part of the structural adjustment, i.e. controlled by public decision makers, is made of**:
  - **the expenditure restraint**, which compares the public spending real growth (calculated with the GDP deflator) to the economy's potential growth. It has a positive contribution to the structural adjustment when public spending grows slower than potential GDP;
  - **the new measures on compulsory levies**.
- **The non-discretionary part** takes into account:
  - the impacts of **changes in revenue elasticities**: since the cyclical component of the public balance is based on average elasticities, the structural balance includes the effects of elasticity fluctuations around the long-term average value;
  - the **changes in revenues other than compulsory levies.**

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[7] The elasticities used in the calculation are the OECD's estimates.

[8] Other expenses are either discretionary, or not clearly linked to GDP.