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France and Europe faced with the economic crisis

PART 4. EUROPEAN FISCAL COORDINATION AND THE NATIONAL BALANCED-BUDGET RULE

The crisis in public finances appears to be the result of macroeconomic imbalances that differ in the various European countries. Although it is commonly acknowledged that the euro area is not an "optimum currency area" (if a shock occurs, countries are affected in different ways without a stabilising force coming into play : reallocation of labour or fiscal transfers), what the crisis has emphasised is the need to set up more effective European and national prevention and coordination mechanisms. Thus, the Stability and Growth Pact, an essentially preventive instrument, did not stop a country like Greece from getting itself into a very difficult situation. It also seems that adhering to the fiscal criterion alone is insufficient, as Spain and Ireland have demonstrated, and that other macroeconomic imbalances must be taken into account. But, even though the determination of the European States to create a guarantee fund for countries in difficulty is unprecedented, the temporary nature of the measures and the urgency with which they have been adopted highlight the need for Europe to set up explicit crisis management mechanisms. Finally, the strengthening of European coordination must be accompanied by strict internal fiscal discipline, always depending on the specific features of each country. For instance, France must, in particular, combat its recurrent inability to return to balance at the peak of the business cycle. ■

PROPOSALS

1. Improve the transparency of all public statistics by explaining and standardising national and European forecasting assumptions and by strengthening Eurostat's investigative powers.

2. Define permanent crisis management mechanisms at European level, either by means of a permanent fund or by means of an arrangement for mobilising resources in an almost automatic manner, should the need arise.

3. Based on the conditions applicable for supporting States in difficulty contained in the Treaty on the Functioning of the EU - improve the monitoring of macroeconomic imbalances, in particular by including private financial balances.

4. Improve the working of the Stability and Growth Pact by backing it up with ambitious national fiscal rules – and ensuring that they are complied with. Thus, France could adopt a balanced-budget rule by setting a medium-term structural balance objective (during the annual review of the draft budget) ; fiscal discipline would be based on a ceiling for the balance between new expenditure and new tax measures.

ALTHOUGH IT HAS BEEN EVIDENT FROM THE START THAT THE EURO AREA IS NOT AN "OPTIMUM CURRENCY AREA", THE FINANCIAL AND PUBLIC FINANCE CRISES HAVE HIGHLIGHTED SOME OF ITS IMPERFECTIONS EVEN MORE

Since the start of its construction at the end of the 1980s, the euro area has been the subject of criticisms from economists. While the gains for the member countries are evident today, some of these criticisms, especially those concerning the lack of robust stabilising mechanisms when the countries within it are diversely affected by the same shock, are still pertinent. Therefore, the determining factors of the current crisis within the euro area should be sought in the very foundations on which monetary union is built.

The euro area still lacks corrective mechanisms in cases of asymmetric shocks

It is well known that a monetary union without fiscal coordination is, by necessity, incomplete. The theory of optimal currency areas explains that, in practice, if countries decide to link their exchange rates, and in effect form a monetary union, and that prices and wages are relatively inflexible between them in the short term, then factors of production, especially labour, must be mobile. If a crisis occurs that affects the member countries differently, i.e. an asymmetric shock, labour can then be reallocated to the regions that remain the most dynamic in spite of the crisis. Though this mechanism works relatively well in the United States, the European Union does not enjoy this advantage, for several reasons, in particular the lack of a common language.

This leaves fiscal policy, which can be used to support activity in the hardest hit regions by means of transfers. Transfers in federations are generally contained in the federal budget - in the United States, for example. However, no mechanism fulfils such a function in the euro area, which is therefore doubly incomplete.

Although some criticisms formulated when the euro was set up remain pertinent and continue to be put forward, there seems to be an emerging consensus among economists that considers this movement to be irreversible (calling the euro into question would be the "mother of all financial crises") and that a way of getting this monetary union to work better must therefore be found.

In spite of the real convergence of living standards between EU Member States, the last decade has also been marked by persistent differences

Average per-capita living standards in the EU Member States have been converging over a very long period[1]. However, it must be acknowledged that, during the last decade, significant macroeconomic imbalances have accumulated in certain euro area countries particularly affected by the crisis. However, the current acute tensions have been caused less by the crisis and the asymmetric shock than by older asymmetric trends.

The divergences between certain euro area countries are of two orders, as the study of the two symbolic cases of Greece and Spain shows. In 2004, the Commission started proceedings against Greece for having reported falsified public deficit figures, but abandoned them in 2007. However, it is reasonable to assume that lingering doubts about the reliability of the figures are one of the reasons why the financial markets are currently wary of Greece. Therefore, the Commission recently proposed that it should be given strengthened audit powers in cases of suspicion about the quality of the data produced.[2] Within this framework, Eurostat would be charged with carrying out more frequent inspections and could consider additional methodological inspections if the risk assessment was unsatisfactory. In addition, the European statistical office would be granted the right to carry out its own checks, with direct access to the data and the full collaboration of the national authorities.

(1) Here, we are only talking about the EU-15 because not enough time has passed to assess the real convergence of the new members.

(2) Draft Council regulation concerning the modification of regulation (EC) n° 479/2009 on the quality of statistical data in the context of the procedure concerning excessive deficits, 15 February 2010 (COM(2010)53 final).

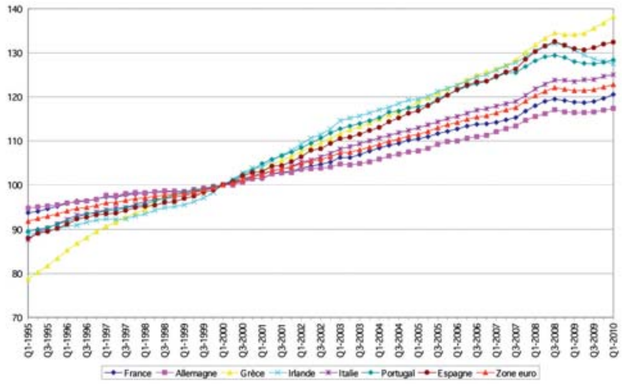
PROPOSAL 1

Improve the transparency of all public statistics by explaining and standardising national and European forecasting assumptions and by strengthening Eurostat's investigative powers.

The case of Spain is different : it has not been the subject of any suspicion and did not present problems of fiscal discipline because it was in surplus from 2005 to 2007. Nevertheless, it suffered a reduction in competitiveness, which led to a deterioration of its current account, accompanied by a sharp increase in private indebtedness and inflation, linked, in particular, to a property bubble. When the crisis broke, it caused a fall in property prices leading to severe recession and a deterioration in public accounts. The example of Spain shows that adhering to the Stability and Growth Pact (SGP) cannot prevent divergences in competitiveness, which ultimately accentuate public deficits. For completeness, it should be noted that, in addition to problems concerning the reliability of its public statistics, Greece also experienced a significant deterioration in its competitiveness due to higher inflation than in the rest of Europe, just like Portugal and Ireland *(graph 1)*. Moreover, the changes in inflation track those in labour costs for the same countries *(graph 2)*. These countries have fallen even further behind Germany on this relative indicator, even though the crisis has lessened the divergences (particularly for Ireland).

Graph 1 :

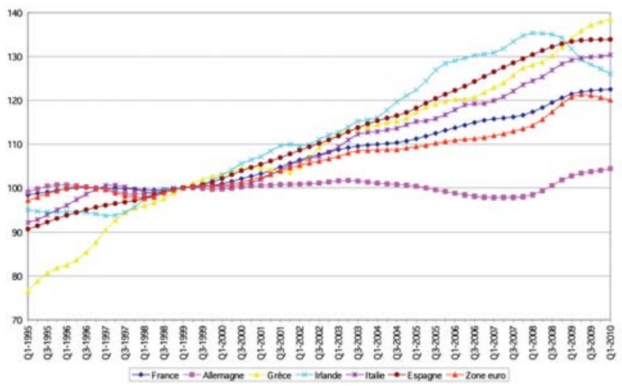
Changes in the harmonised quarterly index of consumer prices, 1995-2010
(first quarter 1999 = 100)



Source: OECD

Graph 2 :

Changes in trend-cycle quarterly unit labour costs,[3] 1995-2010
(first quarter 1999 = 100)



Source: OECD

In addition to the lack of reliability and uniformity of public statistics in Europe, the crisis also showed up two of the main weaknesses of the European institutions : 1) the lack of a permanent crisis management mechanism, which forced them to intervene after the fact, and with a certain urgency ; 2) the limits it exposed with respect to the Stability and Growth Pact, due, in particular, to the difficulty of applying sanctions and focusing exclusively on fiscal policy. This article will look successively at these two criticisms and the responses that could be made.

(3) Trend-cycle unit labour costs represent the proportion of all labour costs in terms of total production, to which a filter is applied with the aim of eliminating cyclical effects.

DEFINING SUSTAINABLE CRISIS MANAGEMENT MECHANISMS AND STRENGTHENING FISCAL COORDINATION IN THE EURO AREA

The sharp tensions that the euro area is currently experiencing are due to the lack of an explicit crisis management mechanism. The urgent need to implement fiscal coordination between Member States can be seen as similar to that which drove the same States to accelerate the introduction of the euro during the European Monetary System crisis in 1992-1993. The financial stabilisation mechanism requested by the Council on 7 May 2010 is an ambitious response to the crisis. However, it will still be necessary to find a way of making such a mechanism sustainable, and supplementing it where required.

Management of the crisis resulted in extending financial support to member countries in the euro area, while complying with the Treaty to the letter

In addition to the specific support for Greece,[4] during the European Council meeting on 7 May 2010, European Union Member States decided to create a financial support mechanism that can be used, when necessary, to refinance States in the euro area when this is no longer possible in the financial markets. It takes the form of a system based principally on the States, supported by the European Commission and the IMF, capable of mobilising 750 billion euros, if necessary.

While the spirit of the Treaty on the Functioning of the European Union had to be adapted for these emergency measures, the Treaty itself remains intact: there is, in fact, no “no bail-out” principle in the Treaty. True, article 143 explicitly reserves financial help from the EU via conditional loans from the Commission to "Member States with a derogation" and therefore outside the euro area[5]. Hungary, Latvia and Romania, particularly affected by the crisis, have already received support from the Commission within this framework, given the difficulties or the threat of serious difficulties with respect to their balance of payments. However, it would be wrong to interpret article 143 as a no bail-out clause for member countries of the euro area experiencing fiscal difficulties. As a *Policy Brief* issued by the Bruegel think tank[6] rightly states, this article should not be considered to be a no bail-out principle for at least two reasons: on the one hand, EU Member States are still members of the IMF and therefore have access to conditional support, so it would be illogical if the EU did not help them; on the other hand, the possibility of support is not a source of moral hazard if the access conditions are made sufficiently dissuasive.

As financial support for States in difficulty is allowed, without however involving the responsibility of the others,[7] it was decided, on the basis of article 122.2 of the Treaty on the Functioning of the EU,[8] to explicitly consider it for the countries in the euro area as well, via loans raised by the Commission on the financial markets. The outstanding amount of the loans is limited to "the margin available under the own resources ceiling for payment appropriations" in accordance with article 2 of Council regulation n° 407/2010 of 11 May 2010, to guarantee the ability to repay the loans taken out. On the basis of 2007-2013 financial forecasts, the own resources ceiling is 1.24% of EU gross national income per annum, whereas payment appropriations are slightly less than 1% of gross national income (GNI). On this basis, the European Commission can borrow around 0.75% of EU GNI over three years (3 x 0.25%), i.e. a little more than 100 billion euros, to provide support for all member countries. As several member countries outside the area have already been granted a sum of about 15 billion

(4) The euro area countries' support for Greece takes the form of a grant of direct loans by those States of a sum of around 80 billion euros, along with loans from the IMF of up to 30 billion euros. The European Commission only brokered negotiations concerning the conditions in this case.

(5) According to article 139, "Member States in respect of which the Council has not decided that they fulfil the necessary conditions for the adoption of the euro shall hereinafter be referred to as Member States with a derogation".

(6) Marzinotto B., Pisani-Ferry J. and Sapir A. (2010), "Two crises, two responses", *Bruegel Policy Brief*, n° 2010/01, March.

(7) Article 125 enshrines the principle of "no-co-responsibility", according to which neither the European Union nor a Member State is answerable for the commitments of another Member State or takes responsibility for them.

(8) When a Member State experiences difficulties or a serious threat of grave difficulties due to natural disasters or exceptional events beyond its control, the Council, on a proposal from the Commission, can grant, under certain conditions, financial support from the Union to the Member State in question".

euros, the figure currently is a maximum of 60 billion euros of new loans. Although not inconsiderable, this support would not be sufficient if several member countries of the euro area experienced difficulties. An increase in the European budget's own resources could be considered, but this could not be enacted until 2014, which does not deal with the urgency of the situation, not to mention the reluctance that some countries might exhibit in this regard. This is why euro area Member States decided to create an intergovernmental loan mechanism.

The Member States created a special purpose vehicle (SPV), the European Financial Stability Fund (EFSF), outside the EU institutions, capable of borrowing 440 billion euros, guaranteed by euro area Member States up to the level of their central bank's share in the capital of the ECB.(9) This fund should be in a position to lend directly to States, open credit lines for them or buy their bonds, or even take a holding in the capital of certain private banks in difficulty, even if this is still to be defined more precisely. Apparently, the loans will be issued with a maturity of five years and the repayments will only start three years later. In practice, the French and German national parliaments have requested a 20% increase in the funds guaranteed in order to allow for the hypothetical situation where the fund is mobilised in favour of a weakened State, which, by definition, could not contribute its own guarantee. If the mechanism is managed by the European Investment Bank, remuneration will be derived from the difference between the cost of the resources obtained and the rates of the loans granted.(10) Contrary to the specific support for Greece in the form of direct loans by States, the guarantee given by the States in the context of the fund is currently listed among off-balance-sheet commitments, as the impact on their financial situation is subject to the activation of the mechanism. For its part, the IMF is committed to providing a further 50% of all of loans (60 billion euros from the Commission and 440 billion euros from the EFSF), i.e. up to a maximum of 250 billion euros.

For the present, this complex institutional support structure has a defined lifetime. Nevertheless, as Gilles Carrez,(11) the general rapporteur for the budget, remarked, euro area the heads of state or government, in their declaration after the European Council meeting on 7 May 2010, said they were "disposed to set up a solid framework for crisis management, in accordance with the principle of the responsibility incumbent upon the Member States in fiscal matters". Therefore, the special-purpose fund set up for three years could be made permanent. In its communication on 12 May 2010, the Commission remarked that this fund broadly matched the principles on which a robust crisis resolution mechanism should be founded. It could therefore be made permanent, but activated solely in a transitory manner. Financing it and the methods for its activation by countries in difficulty are still to be discussed.

PROPOSAL 2

Define permanent crisis management mechanisms at the European level, either by means of a permanent fund or by means of an arrangement for mobilising resources in an almost automatic manner, should the need arise.

A certain number of more decentralised channels for setting up permanent crisis management mechanisms could be explored. While allowing for a certain amount of pooling, these would, however, give a greater role to the market. Although the SGP was created to frame national fiscal policies in the expectation that the markets would no longer sanction them with different interest rates, it has been noted that, since the crisis, the markets have started to discriminate between countries again, as the divergence

(9) This represents 89.7 billion euros for France, 119.4 billion euros for Germany and 78.8 billion euros for Italy (these figures reflect each country's respective share of total EU population and GDP).

(10) The rates for the loans granted should be aligned to those of the IMF, at about 3.5% over three years. For example, France borrowing at 1.042 over three years in May 2010 (AFT data).

(11) Report n° 2551 of the National Assembly's finance commission on the draft amending the finance bill for 2010.

of spreads shows. So these sanctions by the markets should be noted: they reveal, at least in part, market expectations in terms of national fundamentals, without, nevertheless, underestimating the risk of a sovereign debt crisis resulting from a sequence of defaults and an increase in risk premiums. Therefore, the advantage of low rates that would result from a pooling of European debt should be reconciled with a higher cost of borrowing to discourage behaviours that increase systemic risk. These two distinct objectives cannot be attained by a single instrument. This is why J. Delpla and J. von Weizsäcker(12) have proposed the creation of two types of public debt. The first (blue bond) would be defined as sovereign debt, limited to 60% of each country's GDP, for which they would be collectively responsible,(13) supplemented by a second national debt (red bond).

IMPROVING THE WORKING OF THE STABILITY AND GROWTH PACT BY STRENGTHENING MACROECONOMIC MONITORING OF THE MEMBER STATES

Over and above these crisis management mechanisms, as the difficulty experienced by certain European countries in re-establishing the major macroeconomic balances increases, the need to reform the Stability and Growth Pact to strengthen the preventive part seems increasingly urgent. The different European institutions are proposing more or less substantial modifications,(14) which tend towards a widening and progressiveness of the sanctions, for greater credibility, while taking into account other imbalances than the budget balance alone.

As the May 2010 Carrez report(15) stressed, major progress could be made without any revision of the Treaty. In particular, article 136 of the Treaty on the Functioning of the EU offers the Eurogroup new powers for improving economic coordination. It states that "in order to contribute to the correct working of the economic and monetary union (...), the Council hereby adopts measures concerning the Member States whose currency is the euro to: a) strengthen the coordination and supervision of their fiscal discipline, b) draw up, as far as they are concerned, the guidelines for economic policy, making sure that they are compatible with those adopted for the whole of the Union, and ensure their supervision" *(box 1).* Furthermore, as has already been noted above, these loans from the Commission are granted to the Member States that "experience difficulties or a serious threat of difficulties in their balance of payments" (article 143). Therefore, the focus of European institutions already goes beyond just the budget balance.

The Commission, the European Council and the European Central Bank (ECB) are agreed on the need to modify the Stability and Growth Pact, particularly by strengthening its preventive part with more gradual sanctions applied sooner and over a wider area. This increased progression could allow enough time for "peer pressure" to work on a State that finds itself adrift. Non-financial sanctions, such as limits on a State's right to vote in the Council, are being considered, as are procedural and symbolic sanctions, as well as a broadening of the range of financial sanctions, such as the suspension of the payment of the regional cohesion fund and subsidies related to the CAP. The sanctions are one of the most sensitive and controversial aspects of economic governance and will, no doubt, be the subject of complex discussions. In its proposal 63 of the draft report dated 6 May 2010, the European Parliament considered that the repressive nature of the Stability and Growth Pact was not intended for managing a period of crisis or very slow growth, and that withholding support would reinforce the pro-cyclical nature of the Pact, already criticised in its current form. Faced with the criticisms related to the broadening of

(12) Delpla J. and von Weizsäcker J. (2010), "The Blue Bond Proposal", *Bruegel Policy Brief,* n° 2010/03, May.

(13) In this way, the blue bonds are similar to the proposed eurobond. The incentive for inappropriate behaviour that they may generate is countered by the addition of the red bonds.

(14) Proposals by the Commission: "Enhancing economic policy coordination for stability, growth and jobs – Tools for stronger EU economic governance", 30 June 2010; proposals by the ECB: "Reinforcing economic governance in the euro area", 10 June 2010; intermediate proposals by the European Council following the meetings of the Working Group on Economic Governance, 21 May 2010, 7 June 2010 and 12 July 2010, pending the publication of definitive conclusions in October 2010 (this Working Group comprises the President of the Council, ministers of the Eurogroup, the President of the ECB and the European Commissioner for economic and financial affairs).

(15) *Op. cit*.

sanctions, the ECB has proposed that countries called to order by the Commission should be obliged to demonstrate that the planned sanction is too severe, but the final judgement on the fair degree of severity would require the creation of a body capable of settling the difference between the countries in question and the Commission.

Given the global imbalances of some European countries, such as Spain and Ireland, which the SGP has been unable to prevent due to its attachment to the fiscal criterion alone, one of the key proposals is no doubt the widening of the sanction criteria. In practice, what can be seen in banking crises is a transfer of risk from private agents to the State, which plays the role of "lender of last resort", so it would appear necessary to consider the changes in the financial balances and indebtedness of different private agents as sustainability criteria for public finance[16]. Nevertheless, the effectiveness of these measures will still be dependent on the strengthening of banking regulation at European level in order to prevent the excessive indebtedness of private players.[17]

Box 1 :

The "European Semester", European fiscal harmonisation carried out each year in all of the countries of the Union for reinforcing compliance with the Stability and Growth Pact

The European authorities are agreed on the need for a harmonisation of national budgets, which would result in the creation of a "European Semester", the first of which could take place in January 2011. The "European Semester" would require a preparatory debate at EU level, in several phases, in order to lay down the general guidelines, based on the Stability and Growth Pact and the obligations of the Member States in terms of budget balance. This Semester should start with a meeting of the European Council indicating the strategic lines of economic policy to be followed by the States. These guidelines should be set out in a report used to frame the economic assumptions on which the States would then base the stability programme (or convergence programme for States that are not members of the euro area) submitted to the Commission, plus their proposed national budgets. These two programmes would be created concomitantly in the first half of year N-1 for the budget of year N, in order to ascertain the general orientation of the economic policy of each State. By formulating an opinion on these programmes, the Council and the Commission would be able to act on budget imbalances in advance, and could send their recommendations before the final review of the budgets by the national parliaments. As such, the objective of the Semester is to prevent excessive deficits and ensure that national budgets are consistent with European commitments. The Commission also proposes that national parliaments should be involved in the formulation of these programmes, and should be more closely involved with drawing up the assessment, in the knowledge that they will always remain the only bodies that are competent to vote on national budgets. In the French case, this could take the form of a concomitant review by parliament of the pluriannual programming of public finances and the stability programme sent to the Commission,[18] which should share the same forecasting assumptions.

Another way of combating global imbalances within the EU would be to monitor the divergences in competitiveness between the different countries and therefore record wage and price inflation in order to measure the changes in real exchange rates between European economies. The Commission could be entrusted with this monitoring, as suggested by the working group led by Herman Von Rompuy,[19] with an alert mechanism based on key indicators.

(16) Brand T. and Passet O. (2010), "La France et l'Europe face à la crise économique. Volet 1 : La soutenabilité des finances publiques dans la crise, une analyse internationale", *La Note d'analyse*, n° 191, Centre d'analyse stratégique, June.

(17) In addition, the banking system's lack of cohesion feeds a suspicion of fragility that increases the risk of contagion. See Zsolt D. (2010), "Fiscal federalism in crisis: Lessons for Europe from the US", *Bruegel Policy Contribution*, n° 2010/07, July.

(18) See the May 2010 Carrez report, *op. cit.*

(19) Third meeting on 12 July 2010.

PROPOSAL 3

Based on the conditions applicable for supporting States in difficulty contained in the Treaty on the functioning of the EU, improve the monitoring of macroeconomic imbalances, in particular by including private financial balances.

ENSURING FISCAL RESPONSIBILITY AT NATIONAL LEVEL BY ADOPTING A BALANCED-BUDGET RULE

Greater coordination at European level is dependent upon increased fiscal responsibility at national levell

If fiscal coordination mechanisms are developed further at European level, partly pooling the risks of a deterioration in public finances, it would also seem necessary to strengthen regulations at national level, taking account of the specific institutional features of each country. Member States could thus give guarantees that would make it easier to strengthen the European partnership. Several European countries have instituted reforms that will eventually enshrine robust balanced-budget rules in their Constitution. The German example sets a new benchmark, against which the performances of other European States will be measured *(box 2)*. France, in order not to fall behind and to preserve its capacity to refinance in the financial markets, should also adopt a similar regulation. This is why the President has announced that he wishes to see an obligation by which each new government must commit to a mandatory balanced-budget trajectory and to the date on which the balance of the public finances should be achieved to be written into the Constitution.[20]

Box 2:

Germany's new balanced-budget rule

The willingness of Germany to correct the trend for public indebtedness to increase has led the public authorities to adopt a mechanism called a "brake on debt" *(Schuldenbremse)* to become effective under Basic Law in 2011. This constitutional regulation imposes a rebalancing of public accounts by 2020 by limiting the structural budget deficit to 0.35% of Federal GDP from 2016 and prohibiting any budget deficit at the level of the States from 2020. The estimate of potential growth is based on the method used by the European Commission. Furthermore, the automatic stabilisers selected are those identified by the Stability and Growth Pact (tax revenue, social security contributions and public expenditure related to the employment market). Budget growth elasticity equals 0.5.

However, application of the rule may be suspended under exceptional circumstances (natural disasters, etc.). Outside such circumstances, any deviations found between the structural balance ceiling of – 0.35% of GDP and the actual structural balance should be added into a notional control account that plays the part of a shock absorber. If the accumulated deviations recorded reach 1% of GDP, it is imperative for the government to draw up a strict adjustment plan. However, the measures for discharging the notional account in deficit are limited to 0.35% of GDP and can only be implemented at the peak of the cycle to prevent a procyclical fiscal contraction.

In spring 2010, it was estimated that this new provision alone brought fiscal savings of about 60 billion euros from 2011 to 2016 for the Federal government, or about 10 billion euros per year. In June 2010, with this in mind, the government presented an 80 billion euro fiscal consolidation plan for Germany, over the 2011-2014 period. It is generally considered that the introduction of the "brake on debt" has made Germany the main benchmark in the EU in terms of fiscal discipline in the eyes of the financial markets.

(20) Press release from the office of the President of the Republic dated 20 May 2010, on the conclusions of the second conference on the deficit.

However, economists have shown that the effectiveness of such rules is highly dependent on the country's institutional characteristics; whether it is federal or centralised, according to the type of regime or whether it is governed by a coalition or not. Therefore, the same rules cannot be applied uniformly across Europe. In the case of France, one recurrent problem is that fiscal policy is unable to restore a balance at the peak of the cycle. Thus, even if the crisis had not led to an excessive deterioration of the public deficit, the fact that it started from a weak position before the crisis does not put it in a particularly favourable position. Therefore, a balanced-budget rule that is sufficiently strict to keep the budget in balance in the medium term without reducing the government's options, while at the same time remaining credible in the eyes of the financial markets and European partners would therefore be desirable.

Making the commitments to restore the balance of public finances credible

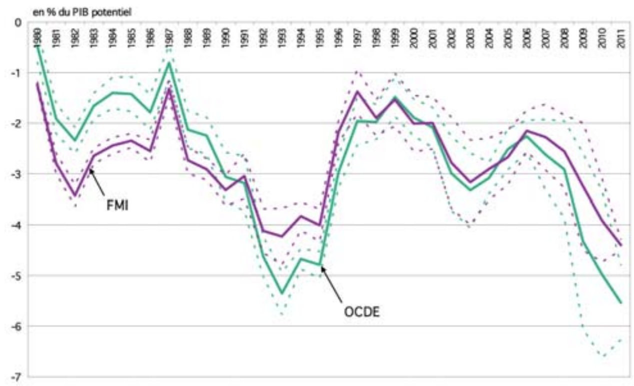
The Camdessus report[21] perfectly defined the debate on the balanced-budget rule in France. In a letter accompanying the report addressed to the Prime Minister, it says that a balanced-budget rule can take two forms: either a rule governing the structural balance or one imposing a ceiling on expenditure and a floor on revenue for the discretionary component of the public finances.[22] The report itself comes out in favour of the second option. These two options both have their own advantages and disadvantages, which are set out in the document referred to above, or have been noted in various analyses[23].

The expenditure ceiling and the revenue floor would only concern the discretionary component and therefore concentrate on new measures. Furthermore, expenditure and revenue would be assessed on a constant-data basis. This restriction would simplify assessments, because any change in scope or transfers would be eliminated, thereby allowing the automatic stabilisers to play their role. In addition, the possibility of adjusting the expenditure ceiling in response to change in the revenue floor, or vice versa, maintains a certain margin of manoeuvre for changing the weight of government intervention in the economy. However, the areas covered by the discretionary component can be affected by permanent shocks or structural trends. So, the effect of shocks on long-term growth (impact of the financial crisis), demographic change or healthcare expenditure, where growth is not necessarily a sign of a deterioration, are largely ignored by this mechanism. Furthermore, the problem of financing implicit debts, such as civil service pensions, the effect of economic stabilisers on potential growth and the impact of future expenditure are not taken into account.

A regulation based on compliance with a structural balance objective also has certain disadvantages. Firstly, it poses a problem of scope, because many expenditures, such as those of local authorities, unemployment benefits and top-up pension schemes, are beyond the reach of lawmakers. Furthermore, while the structural balance is a widely recognised concept used by many countries and international bodies, it is the result of a calculation involving methodological choices that are still a matter of dispute. This calculation is based on data marked by uncertainties and therefore remains subject to numerous and significant revisions, especially at the time of the largest deteriorations in the balance, as the difference between the OECD averages and those of the IMF shows *(graph 3).*

Graph 3 :

Average (to + or – a standard deviation) of the estimates of the French structural budget balance (1980-2011) by the IMF and the OECD in their last 19 reports



Sources: IMF and OECD

(21) *Réaliser l'objectif constitutionnel d'équilibre des finances publiques,* report of the working group chaired by Michel Camdessus, 21 June 2010.

(22) This letter also presents a discussion on the duration of framework budgets (five or three year duration, perhaps rolling) and the methods of associating parliament with the drawing up of the stability programme.

(23) Garnier O. and Pisani-Ferry J. (2010), "Pour une règle budgétaire organique", *Les Échos,* 26 May; Delpla J. (2010), "Pourquoi j'ai voté non au rapport Camdessus sur les règles budgétaires", Blog, *Les Échos:* http://blogs.lesechos.fr/article.php?id_article=4266.

As stated in the Camdessus report, the mechanism chosen may mean that the Constitutional Council has to assess whether budgets comply with budget framework laws. In which case, the simplicity of calculating objectives within the context of a ceiling/floor regulation would be an undeniable advantage. However, it may create the illusion of effective control of the deficit excluding discretionary revenue and expenditure by complying with a framework law to the letter. In practice, any government is invariably subject to various short-term pressures. It could then resort to ways of getting around the law, such as optimistic forecasts at the start of its legislative term in order to give itself a certain margin for manoeuvre, so that it does not have to comply with the spirit of the law in practice. In this case, everything would depend on the ability of the Constitutional Council to strike out in advance any growth assumptions that may be too favourable.

In addition, the uncertainties weighing on the calculation of the structural balance further complicate the assessment of the government's commitment, but experience abroad may suggest at least two ways of circumventing this difficulty. First, an independent fiscal policy council, an institution already set up in several countries, including Sweden *(box 3)*, responsible for judging whether measures are consistent with fiscal commitments. This council takes care to clarify the assessment of compliance with the course prescribed by the framework law and the quality of government forecasting (methods used and comparison with the results of other bodies). Assuming that the measurement is necessarily imperfect by nature, the fiscal policy council focuses on government good faith by affording it a margin of error. Second, the introduction of a notional control account intended to keep account of the accumulated deviations, as in Germany, may strengthen the credibility of the balanced-budget rule. The conditions for recording in the notional account and the choice of threshold values triggering the discharging plans are therefore crucial. In actual fact, they can be used for fine-tuning the inevitable trade-off between flexibility[24] and credibility. A rule covering a structural balance trajectory, ultimately supported by a control account, would enable France to maintain a certain consistency with the German solution and open the way to the possibility of European coordination.

Box 3 :

The Swedish experience of fiscal governance

The Swedish fiscal policy council[25] is responsible for assessing the long-term sustainability of public debt and the effects of fiscal policy on growth and employment. It also comments on the match between the government's economic policy and fiscal choices when the budget is presented to parliament, and assesses the quality of forecasts. Even though it obtains its information from government and parliamentary budget offices and its resources are very limited, its independence is guaranteed by the fact that it is mostly made up of academic economists (including some from abroad) and political personalities who no longer have ambitions of occupying executive or legislative posts. Its members are appointed by the government on proposal from the council (without prior consultation with the executive) and are poorly paid. Documents produced are public and meetings with the government are limited to the submission of analyses. As its members mainly come from the academic world, any incentives to adopt a partisan approach are tempered by the loss of reputation they might incur. Interventions have contributed to improving the quality of economic debate, clarifying restrictive adjudications and revealing some manipulation of accounts in government budget proposals (carrying over expenditures to subsequent years), which enable it to affirm its reputation for independence. Recently, the Swedish fiscal policy council criticised the weakness of the government's stimulus plan during the crisis, in the light of the particularly healthy state of the Swedish public finances, the stability of the banking system and the depth of the recession.

(24) A degree of flexibility may be necessary to take account of revisions of trend growth or any other shock that the government cannot anticipate, but which will have an effect on the calculation of the structural balance.

(25) Calmfors L. (2010), "The Swedish Fiscal Policy Council – Experiences and lessons", paper at the Conference on Independent Fiscal Policy Institutions, Budapest, 18-19 March.

Generally speaking, there is undoubtedly no real contradiction between the two courses considered by the Camdessus report (expenditure ceiling and revenue floor, structural balance) but rather a sequencing in time : the assessment of new expenditures is a good short-term criterion (for looking at a finance bill or a period of two or three years at most), but, in the medium term, setting a target structural balance is essential for mapping out the path for restoring the public finances.

On the question of control, it could either be constitutional or based on an independent fiscal policy council, or a combination of the two. In which case, the creation of an independent fiscal policy council would have two functions. First, it would inform the country(26) about the apparent transparency of the structural budget balance path chosen by the government. Second, it would analyse the impact of new measures, based on how the control account progresses and keeping track of the deviations from the path chosen, to assess government action after the fact. Finally, such a council would endeavour to raise the level of economic debate by improving the sharing of information in terms of forecasts, hypotheses chosen and models used. By assuming the error component implicit in the task of assessment, the independent fiscal policy council would also serve as a reminder that the management of uncertainty should be an integral part of economic policy.

PROPOSAL 4

Improve the working of the Stability and Growth Pact by backing it up with ambitious and adopted national fiscal rules. Thus, France could adopt a balanced-budget rule in the form of the definition of a medium-term objective in terms of the structural balance (during the annual review of the draft finance bill); fiscal discipline would be based on a ceiling for the balance between new expenditure and new tax measures.

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(26) And the Constitutional Council, if it is called on to judge.

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