IMF/FAD Conference on Large-Scale Fiscal Adjustments
Washington D.C., 9th December 2010

Comment on Case Studies for France and Germany

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1. Broad agreement on conclusions for France
2. Environment matters!
3. Lessons for ongoing fiscal adjustment

1. Broad agreement on conclusions for France

- Authors' conclusions
  - Proven ability to consolidate when incentives are there, *e.g.* prior to euro entry (1993-1997) or under European pressure (EDP procedure, 2003-2007)
  - Inability to revert secular trend in general government spending

- Main hurdles to fiscal adjustment:
  - Underlying dynamism of public spending due to gradual extension of welfare state and expansion of local governments
  - Until recently, lack of binding multi-year framework
  - Excessively narrow scope of fiscal rules (too focused on central government)
  - Pro-cyclical bias = tendency to increase spending and/or cut taxes at peak of business cycle (*e.g.* late 1990's)

  - *Other driving force, not mentioned in the paper: fiscal rules focused on spending rather than revenues => proliferation of tax exemptions ('niches fiscales') leading to an erosion of tax base*

2. Environment matters!

- Authors rightly emphasize importance of structural reform
  - Breaks in potential growth rate (*e.g.* secular shift to services economy in Germany and France, negatively impacting TFP) have contributed to deficits => to be remembered in a post-crisis environment
  - Lessons of successful German adjustment of 2003 versus failed adjustment of 1975:
    - Importance of combining consolidation plans with policies enhancing potential growth, private sector competitiveness, and lowering structural unemployment (Hartz package)
    - VAT/social contribution switch = more a pro-growth reform than a fiscal consolidation instrument
  - Need to mitigate potentially adverse impact of fiscal consolidation on growth

The consequences of fiscal shocks in France

Nature of shocks	GDP impact after 2 years
Fiscal consolidation	2.2*
TFP-enhancing	1.1*
Competitiveness	0.3
Employment	-0.2
Social transfers	0.9
Income taxation	-0.6
Sovereignty	0.1

Source: Cahu and Doisneau (2010), based on 777 fiscal shocks in France in the period 1952-2008
* denotes 5% significativeness

2. Environment matters (cont'd)

- Authors underestimate the importance of macro environment
  - "Good political fortune" matters… but good economic fortune matters even more
  - FAD cross-country study (presented earlier in the conference) highlights the contribution of growth shocks to the (non-) realization of fiscal plans
  - Paper should discuss in more details role of monetary policy (cf. October 2010 WEO), exchange rate policy (particularly important in the EMU context), oil shocks, etc.
- What about market discipline?
  - Market discipline was non existent in 1999-2009 but it did matter under the EMS and will matter again now that bond price discrimination is back

3. Lessons for ongoing fiscal adjustment

- To wrap up, successful large-scale adjustment relies on three pillars:
  - Pro-growth environment
  - Changing attitude towards big government
  - Effective fiscal framework

- Against this background, will the ongoing fiscal adjustment in France be successful?
  - Deficit to be cut from 7.7% of GDP in 2010 to 3% in 2013
  - Structural adjustment worth 1.6% of GDP in 2011

✓ Pro-growth environment?

- Accommodative monetary stance…
- Structural reform…
  - Competition (retail trade, electricity)
  - Capital taxation (termination of the *taxe professionnelle*), R&D expenditures (“*grand emprunt*”), pension reform
  - Possible Ricardian effect of fiscal consolidation on consumption
- … but impact of crisis on potential growth is uncertain
  - Impact mainly channeled through capital expenditures and higher structural unemployment, possibly through TFP

✓ Changing attitude towards big government

- Some transitional dynamics which have contributed to public spending are now over
  - Expansion of local governments
  - Introduction of new, costly welfare schemes
- No appetite in France for small government, quite the contrary
  - See ongoing discussion on new universal support to long-term care
- Balancing act will depend on ability to raise taxes
  - Window of opportunity: halt to race-to-the bottom in corporate taxation

✓ Effective fiscal framework?

- Multiyear planning
  - In place and binding ("*Loi de programmation des finances publiques*") with revenue floors and spending caps
- Better coverage
  - Progress achieved on covering social security (*e.g.* on health-care)
  - Less so on local governments, even though limitation of State transfers and reform of local business tax will contribute
- New focus on tax ependiture
  - Political resolve to address excessive tax deductions (€10bn cut over 2011-2013)
  - Any new tax exemption will have to be decided in budget law
- Procyclical bias
  - Revised Stability and Growth Pact with sanctions kicking in earlier and more automatically – see Van Rompuy Task Force conclusions

Conclusion

- Steps taken towards structural reform both in France and Germany throughout the crisis

- Focus on improving fiscal rules in both countries
  - But framework is less formal and therefore more fragile in France than in Germany
  - Need for constitutional rule in France, see Camdessus report

~ Thank you for your attention ~