



# Putting French public finances on a sustainable footing

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France's public finances have deteriorated sharply in recent years. This is due to the health crisis, the “tariff shields” introduced to cushion the impact of rising energy prices and also unfunded tax cuts. By 2023, public debt has reached around 110 points of GDP and the public deficit 5.5 points of GDP.

Future governments will face a twofold challenge. On the one hand, France must reduce its public deficit in the coming years. This is an essential condition to guarantee debt sustainability, to continue to finance itself at low interest rates and to meet its European commitments. On the other hand, in order to safeguard growth and avoid a rise in unemployment, France must avoid consolidating too quickly and make prudent choices in its management. This *Note* describes public finance strategies that are compatible with these constraints, taking into account the headwinds of demographic ageing, the necessary energy transition and the resurgence of geopolitical risks.

The *Note* begins by documenting the historical evolution of the French public debt, which has risen from around 20 points of GDP in the 1970s to 110 points today. This increase mainly reflects the accumulation of primary deficits, i.e. deficits excluding government interest charges. In fact, growth rates and interest rates on debt have more or less neutralised each other in the long run. This is important

for two reasons. Because it means that France remains in control of its debt but also because it means that France cannot count on favourable macroeconomic conditions to automatically reduce its debt ratio. Any reduction in the debt ratio will therefore have to be achieved by generating primary surpluses. The *Note* recommends a primary surplus target of around one point of GDP over the medium term in order to stabilise the debt, while maintaining room for manoeuvre to deal with future crises.

The *Note* then considers the medium-term path to achieve this stabilised situation. Going too fast risks hampering growth but a too slow consolidation would increase debt and risks for financing costs, investment and France's credibility. The *Note* proposes a moderate but sustained adjustment involving a reduction in the primary deficit of around 4 points of GDP, or €112 billion, spread over 7 to 12 years, with a larger initial effort. This adjustment will make it possible to stabilise the debt and achieve the primary surplus target. It is essential that this effort be credible, which requires changes in the institutional arrangements for the monitoring and control of public finances.

Finally, the *Note* discusses potential avenues for deficit reduction on both the expenditure and the revenue side.

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## A brief history of government debt

Figure 1 shows the evolution of government debt in five euro area countries. In 1970, debt was around 20 percent of GDP in France and Germany, 40 percent in Italy and 50 percent in the Netherlands. In 2023, debt will hit around 140 percent of GDP in Italy, 110 in France and Spain and 60 in Germany. We therefore observe a trend towards an increase and a growing divergence in average debt levels, especially between France and Germany.

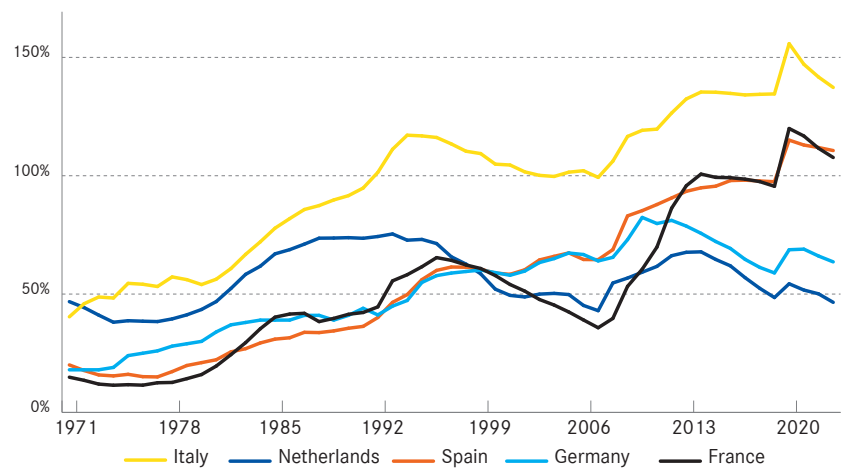
How can we analyse these trends? Three main factors explain the debt dynamics: the primary deficit, the interest burden and GDP growth.

Debt increases with the primary deficit (public expenditure excluding interest charges minus revenue) and interest on the debt. For example, in May 2024, the French National Institute of Statistics and Economic Studies (INS) published the figures for 2023 (national accounts base 2020): total public expenditure excluding interest totalled 1,€558 billion and total revenue amounted to 1,€454 billion, leading to a €104 billion primary deficit. Adding €50 billion in interest payments gives a total deficit of €154 billion, corresponding to 5.5 points of GDP. The debt has therefore increased by around €154 billion - slightly less due to a "stock-flow adjustment" corresponding to the government's financial transactions of around €6 billion - rising from €2,953 billion at the end of 2022 to €3,101 billion at the end of 2023. This amounts to an increase of 5% in the debt stock.

A country's debt level is to be appreciated relative to its tax capacity, which is in turn proportional to its gross domestic product (GDP). All else being equal, high nominal growth (inflation plus real growth) reduces the debt ratio. France's GDP will rise from €2,655 bn in 2022 to €2,822 bn in 2023, a nominal increase of 6.3%. This results in GDP growth being higher than the increase in the debt stock (5%); the debt-to-GDP ratio therefore falls from 111.2% at the end of 2022 to 109.9% at the end of 2023.

Box 1 decomposes the evolution of the debt-to-GDP ratio into the direct primary deficit effect (including stock-flow adjustments) and an accumulation or "snowball" effect, which depends on the difference between the real interest rate  $r$  and the GDP growth rate  $g$ . On the one hand, when  $r - g$  is positive, debt accumulates faster than GDP. Without primary deficit adjustments, the ratio tends to explode. As we shall see below, this is the problem faced by a country such as Italy. On the other hand, if  $r - g$  is negative, economic growth mechanically reduces the debt ratio, as was the case during

Figure 1. Public debt as a % of GDP for 5 European countries, 1971-2023



Source: OCDE and calculations by the authors.

the French Trente Glorieuses, a thirty-year period between 1945 and 1975 during which France experienced rapid economic growth, following the end of the Second World War.

### Box 1. Public debt dynamics

If  $B_t$  represents the debt stock at the end of year  $t$ , the accounting equation linking the change in the level of debt  $B_t - B_{t-1}$ , the primary deficit,  $D_t$ , and the so-called «stock-flow adjustment»  $S_t$  is as follows

$$B_t - B_{t-1} = i_t B_{t-1} + D_t + S_t$$

où  $i_t$  where it denotes the apparent nominal interest rate on public debt. The debt-to-nominal GDP ratio,  $b_t = B_t / GDP_t$ ,  $b_t = B_t / GDP_t$  therefore evolves according to equation (1):

$$b_t - b_{t-1} = \left( \frac{i_t - g_t^n}{1 + g_t^n} \right) b_{t-1} + ds_t$$

where  $g_t^n$  is the nominal GDP growth rate, and  $ds_t$  is the ratio of the sum of the primary deficit and the stock-flow adjustment ( $D_t + S_t$ ) to GDP.

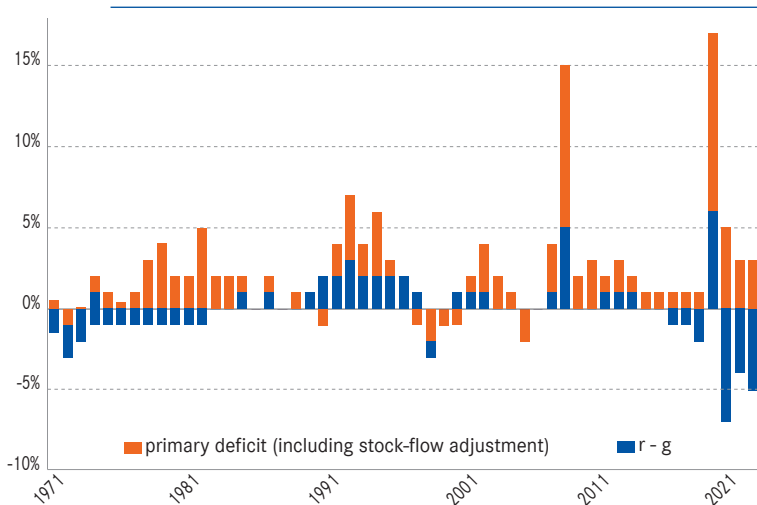
Nominal growth is the product of real growth  $g_t$  and inflation  $\pi_t$ :  $1 + g_t^n = (1 + g_t)(1 + \pi_t)$ <sup>a</sup>. Similarly, we define  $r_t$  the apparent real rate as  $1 + i_t = (1 + r_t)(1 + \pi_t)$  and rewrite equation (1) as :

$$b_t - b_{t-1} = \left( \frac{r_t - g_t}{1 + g_t} \right) b_{t-1} + ds_t$$

<sup>a</sup> We define  $\pi_t$  as inflation between year  $t-1$  and year  $t$ , measured by the growth rate of the GDP deflator. This measure differs slightly from inflation measured by the consumer price index; this difference can become significant when comparing price levels over several decades.

<sup>†</sup> The authors would like to thank the permanent team of the ACE for monitoring this Note, in particular Jean Beuve, Scientific Adviser, Circé Maillet, Research Officer, and Garance Desrousseaux. They would also like to thank Olivier Blanchard, from MIT, and the members of the ACE for their invaluable advice.

**Figure 2. Economic breakdown of change in debt as % of GDP, 1970-2023**



Sources: INSEE (national accounts) and Jordà-Schularick-Taylor Macrohistory database for public debt before 1978, calculations by the authors.

Figure 2 shows the  $r - g$  snowball effect on the debt ratio, reducing it in the 1970s and increasing it in the 1980s. We also clearly see the impact of crises (2008, 2020) and inflation (2022) on the growth rate. The primary deficit,<sup>2</sup> on the other hand, has almost always been positive and has tended to increase in recent decades.

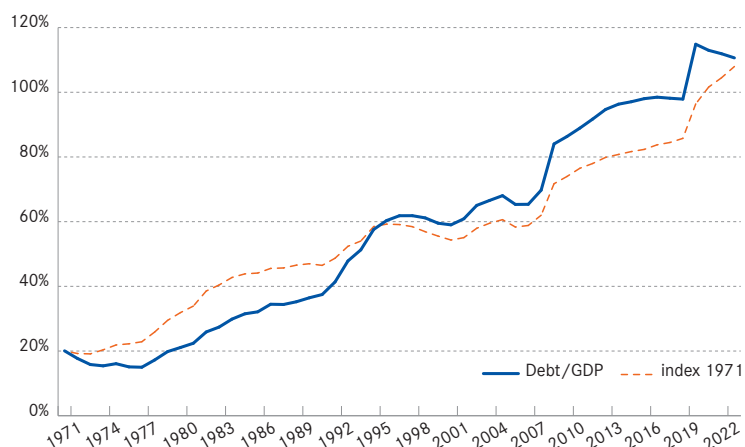
This historical study of the French debt ratio reveals a remarkable and somewhat unexpected fact. French public debt reached 110 points of GDP in 2023, compared with 21 points in 1970, an increase of almost 90 points. Over the same period, the sum of primary deficits and stock-flow adjustments amounted to 88 points of GDP, i.e. almost the entire increase in debt. The public debt is thus the result of past primary deficits accumulation. The snowball effect is close to zero on average over the period.

Figure 3 illustrates this result by taking the debt-to-GDP ratio at the end of 1970 as a starting point and simulating its evolution under the assumption of the absence of snowball effect ( $r = g$ ). The inflation in the 1970s and 1980s was favourable for the debt-to-GDP path compared to this counterfactual path. The low growth in the 1990s and 2000s and during the two recent crises then reversed this difference, so that the current level of government debt can be explained entirely by the accumulation of past primary deficits.<sup>3</sup>

This result entails good and bad news. The good news is that France has so far remained in control of its own destiny. Our debt is the direct result of our budgetary choices and not the mechanical accumulation of a snowball thrown down a steep hill. The bad news is that we should not expect a macroeconomic miracle. Indeed, it is highly unlikely that inflation or growth will systematically reduce public debt without a budgetary effort, in line with our  $r = g$  assumption. First, the nominal interest rate rises with inflation expectations. Second, the real interest rate tends to rise when growth is strong, despite a weak relationship in the short run. Accordingly, we have seen in recent decades a decline in both nominal interest rates and nominal growth.<sup>4</sup> Uncertainties notwithstanding, the assumption of a value of " $r - g$ " close to 0 therefore seems to be the most relevant starting point for projecting the future of public finances.

However, our hypothesis requires France's debt to remain on a sustainable path in order to prevent borrowing rates ( $r$ ) from rising as a result of savers or financial markets' worries. Reducing France's debt ratio is therefore not a sole constraint inflicted upon taxpayers by Brussels; it also aligns with taxpayers interests.

**Figure 3: Debt and counterfactual path with  $r = g$**



Note: the dotted line shows the counterfactual trajectory of the debt resulting simply from the accumulation of historical primary deficits and stock-flow adjustments, i.e. by making the counterfactual assumption that in equation (1) we have  $i_t = g_t^1$ , and that the first term is therefore zero.

Sources: INSEE (national accounts), and Jordà-Schularick-Taylor Macrohistory database for public debt before 1978, calculations by the authors.

<sup>2</sup> The primary deficit is used here, including stock-flow adjustments.

<sup>3</sup> Whether the observed ratio is identical to the counterfactual ratio at  $r - g = 0$  depends on the starting point of the simulation. As can be seen in Figure 3, there can be differences of around 10 points of GDP. In fact, the standard deviation between the observed debt ratio and its counterfactual is 10%.

<sup>4</sup> Economic theory suggests that there are several forces that will affect  $r - g$  in the future, such as demographic change, increasing levels of public debt in many countries, changes in the competitive structure of the economy, or technical progress. These forces act in opposite directions and the total effect on  $r - g$  is ambiguous, which reinforces the plausibility of a baseline scenario of  $r - g = 0$ . See Eggertsson G., N. Mehrotra, Jacon Robbins (2019): "A Model of Secular Stagnation: Theory and Quantitative Evaluation", *AEJ Macro*; Auclert A., Malmberg H., Martenet F., Rognlie M. (2021): "Demographics, Wealth and Global Imbalances in the Twenty-First Century", *NBER Working Paper*; Blanchard O. (2022): "Fiscal Policy Under Low Interest Rates", *MIT Press*; and Claveres G. (2023): "Taux d'intérêt, croissance et soutenabilité de la dette publique", *Note du Trésor-Eco #334*.

## Medium-term outlook: achieving a primary surplus of 1% of GDP

Assuming that  $r - g = 0$ , we immediately see that in order to stabilise the debt ratio at its current level, the government must reduce its primary deficit to 0; in order to reduce the debt ratio in a sustainable way, it must achieve a primary surplus<sup>5</sup>.

This primary surplus target is not necessarily more restrictive than the European commitment to a (total) government deficit of less than 3 points of GDP. Additionally, it makes more economic sense. In fact, the government deficit is the sum of the primary deficit and the interest burden. With a nominal interest rate of 3% and a debt-to-GDP ratio of 100%, the government deficit will be 3% if the primary deficit is 0%<sup>6</sup>. A nominal interest rate of 3% is a realistic assumption for the medium term, based on an inflation rate of 2% and a real interest rate of 1%.

Turning to the medium-term horizon of 2030, we assume in this case that the debt is stabilised at a level of 116 points of GDP, in line with the International Monetary Fund forecasts of April 2024<sup>7</sup> and many other forecasting institutes.

To satisfy our  $r = g$  assumption, we then assume that inflation will have returned to the European Central Bank's target of 2%, that real GDP growth will be 1%, its average over the last 10 years, and that the average interest rate on government borrowing will be 3%.

What would the right primary surplus target be in this context? To answer this, we need to account for the risk of a crisis. Figures 2 and 3 clearly show that several major shocks have affected government deficit: in 2009 (after the financial crisis following the collapse of Lehman Brothers, leading to a primary deficit + stock-flow adjustment of almost 10 points of GDP) and again in 2020 (following the Covid 19 outbreak, leading to a primary deficit + stock-flow adjustment of almost 11 points of GDP).

The contribution of major economic shocks to the increase in government debt in France since 2007 is difficult to estimate. It indeed implies assessing the government crisis management, and whether it emitted too much or too little debt as a response. An OFCE estimate suggests that crises have

contributed to half of the increase in government debt since 2007,<sup>8</sup> or around 22 points of GDP of the 45 points of GDP increase in debt between 2007 and 2023.<sup>9</sup> Unfortunately, such crises will likely continue to hit the French economy, necessitating further emergency spending.

A simulation of the evolution of the debt ratio after 2030, with and without crises, gives the following results. A primary surplus of 1% of GDP sets the public debt on a long-term downward path in a crisis-free scenario, with the debt ratio falling below 100% around 2045. If a major shock of 10 points of GDP were to hit our economy every 10 years, our recommendation of a 1% primary surplus outside the shock period would still make it possible to ensure public debt long-term stability, while providing responses to crises. The debt would not return to the 60% level, but would remain stable at around 110%.

Over the 1995-2024 period, the effect of the 22 points of debt associated with the crises is equivalent to about 7 points of GDP every ten years. This historical average leads us to believe that the most likely debt trajectory, provided that our primary surplus target of 1% is met, lies between the two extreme cases just described.

The case of Italy illustrates the need to control debt dynamics before interest rates rise. Italy's debt ratio rose sharply in the 1980s, leading to a situation where  $r$  exceeded  $g$  for a long time. In order to reduce the debt ratio, Italy had to run large primary surpluses from the mid-1990s onwards, but this left the debt at a high level, above 100% of GDP. The need to respond to the crises between 2007 and 2023 then caused the debt to rise above 140% of GDP, leading to a further increase in the sovereign spread and thus in  $r$ . In this situation, debt is rising despite a positive structural primary balance, leading the country into a cycle of enforced austerity and reduced public investment<sup>10</sup>. The weakness of the growth rate  $g$ , due in particular to sluggish productivity, makes the adjustment all the more difficult.

### A major effort in the face of headwinds

We have shown that a primary surplus of around 1 point of GDP is needed. We will now discuss the structural trends affecting the primary deficit in order to assess the necessary fiscal effort. Such a surplus is very high in the history

<sup>5</sup> More generally, for a given rate  $r - g$ , the long-term primary deficit compatible with stabilising public debt at a level of  $b\%$  of GDP is  $-((r - g)/(1 + g))b$ . For example, if the interest rate exceeds the growth rate by 1%, and the debt is 100% of GDP, stabilising the debt/GDP ratio requires a primary surplus of around 1%.

<sup>6</sup> In the short term, France is benefiting from the favourable effect of borrowing at exceptionally low rates over the last ten years, so the 0% primary deficit target is indeed more restrictive than the 3% deficit target. However, it is clear that rapid fiscal consolidation is difficult. We will deal with the short-term transition in the third part of this Note.

<sup>7</sup> *World Economic Outlook*, April 2024

<sup>8</sup> Source: Plane M., Ragot R. and Sampognaro R. (2024): "Les crises expliquent-elles la hausse de la dette publique en France?", *OFCE le blog*, 24 May.

<sup>9</sup> The other half of the increase in debt is explained in particular by new measures, on both the expenditure and revenue sides. By way of illustration, it should be remembered that all the new permanent measures adopted on the revenue side over the period 2018-2023 (excluding those linked to the tariff shield) correspond to €62bn, or just over 2 points of GDP.

<sup>10</sup> Antonin C., Guerini M., Napolitano M. and Vona F. (2019): "Italy: getting out of the double trap of high debt and low growth", *OFCE Policy brief* 55, 14 May.

of French public finances, but has been achieved by many countries.

A number of structural trends tend to push the deficit up and therefore require a greater fiscal effort from the rest of the budget. In 2023, government expenditure excluding interest payments will amount to 55 points of GDP. This number includes all other general government expenditure, such as spending on pensions, health, social protection (unemployment, etc.), education and defence. Revenue amounted to 51.5 points of GDP. This figure includes receipts from social contributions, VAT, income tax and corporate tax. The difference between expenditure and revenue therefore explains the primary deficit of 3.5 points of GDP in 2023 (government deficit of 5.5 points minus 2 points for interest charges).

Pension expenditure is the largest item of public expenditure, while the social contributions that finance these pensions are the largest item of revenue. Hence, even a modest proportional change in the level of these expenditures and revenues has a large impact on government's deficit. However, in a pay-as-you-go system, where pensions are financed by workers' contributions, population ageing tends to increase expenditure and reduce revenue. This negative mechanical trend is nonetheless mitigated by the effect of past reforms, which postpone the retirement age and gradually reduce effective replacement rates. Thus, in some projections by the Conseil d'Orientation des Retraites (COR), the impact of ageing on pension expenditure is neutralised by a relative reduction in old-age pensions. Yet, the increase in productivity is an essential element in this calculation: since entitlements (old-age pensions and, above all, the wages entered in the account used to calculate the average annual reference wage) are indexed to prices and not to wages, an increase

(decrease) in labour productivity causes the average level of pensions to fall (rise) relative to the average level of wages. The central scenario of the COR of a labour productivity level of 1% is rather optimistic. A more pessimistic scenario of 0.4% labour productivity growth, as tested by the COR in its latest report (June 2024), would imply an increase in the primary deficit of around 1.7 points by 2070 (table, last column).<sup>11</sup>

The table also shows the potential impact on the primary deficit of the green transition and the strengthening of defence capabilities in an increasingly tense geopolitical context. According to the Mahfouz and Pisani-Ferry report,<sup>12</sup> the green transition will require public investment of around 1 point of GDP in 2030 - partly financed by the reallocation of public spending that is holding back the energy transition - which will gradually decline, but it cannot be ruled out that the public effort will be more sustained for longer period.<sup>13</sup> Similarly, France's defence budget currently stands at 1.8 points of GDP. If geopolitical tensions persist, this ratio will increase in the coming years, possibly back to Cold War levels (around 3 points of GDP).

These elements show that the objective of achieving a primary surplus of 1 point of GDP in 2030 and maintaining it at that level in the long term will face significant headwinds of the order of several points of GDP, which will therefore require a higher primary surplus excluding these measures. The severity of these figures is mitigated by the hope that, unlike ageing, the climate change transition and the increase in military spending are temporary phenomena that can be financed by reallocating current public spending, cutting down for instance brown spendings, which contributes negatively to the energy transition

**Table: Calculation of the effects of headwinds on the primary deficit over the medium term**

Effect \ Horizon	Effect on the primary deficit relative to 2023 (% of GDP)			
	Optimistic scenario		Pessimistic scenario	
	2030	2070	2030	2070
Ageing population (pensions)	0,3	-0,2	> 0,3	1,7
Green transition	1	0	2	1
Military expenditure	0,5	0	1	1
Total	1,8	- 0,2	> 3,3	3,7

<sup>11</sup> The dependence of pension expenditure on economic growth has been highlighted in numerous studies. Over time, and with growth, salaries increase faster than the salaries entered in the account (which are revalued in line with prices), causing the reference salary to fall in relation to the last salary received. This method of indexation entails a major risk for public finances by making the financial balance dependent on the pace of economic growth. Reform proposals have been put forward to improve the steering of the system, see in particular: Bozio A. and B. Dormont (2016): "Gouvernance of the Social Protection: transparency et effectiveness", *Les Notes du CAE* no. 28, January.

<sup>12</sup> "Les incidences économiques de l'action pour le climat", by Jean Pisani-Ferry and Selma Mahfouz, report to the Prime Minister, May 2023.

<sup>13</sup> It should be noted, however, that all investments in favour of the ecological transition made at carbon abatement costs below the cost of damage (estimated at around €500 per tonne) are socially profitable. The associated additional debt is therefore less of a problem for investors.

## From 2024 to 2030: what is to be done? The trade-off between fiscal consolidation and growth

In order to achieve a primary surplus of around 1 point of GDP, and given that, according to the French Treasury, the starting point is a structural primary deficit of 3.2 points of GDP in 2023, at what pace and along what path should France pursue this consolidation of just over 4 points of GDP? This section analyses the optimal consolidation path in a simple macroeconomic model (presented in detail in the *Focus* accompanying this Note).<sup>14</sup>

The main ideas are as follows. First, consolidation should be progressive and result from a series of budgetary measures that gradually improve the structural primary deficit. Thus, consolidation on the expenditure side is to be achieved by limiting its growth relative to GDP. Similarly, consolidation on the revenue side is to be achieved through a gradual increase in the compulsory tax rate. In both cases, the primary structural deficit ratio improves throughout the consolidation process.

The pace of consolidation is the result of a trade-off between the necessary consolidation and the impact of fiscal restraint on aggregate demand. Consolidation measures, whether through expenditure cuts or revenue increases, are likely to have a negative effect on economic activity in the short run. This effect is measured by fiscal multipliers, which summarise the impact of fiscal policy on economic activity. The size of these multipliers is a topic of ongoing economic debates, with most estimates ranging between 0.3 and 1.5. Multipliers depend on the nature of the investigated fiscal policy (whether it involves tax increases or expenditure cuts, distinguishing between transfer, operating or investment expenditure), the accompanying policies (mainly monetary policy)<sup>15</sup> and the macroeconomic environment (in particular the fiscal policies of the main economic agents). They also depend on the macroeconomic context: budget multipliers are higher in times of crisis. This supports a strategy that favours, as a first step, measures with relatively low multipliers and reforms that promote credibility but have little negative impact on demand.

Our model takes into account the macroeconomic closure of public finances. When fiscal restraint measures affect growth, they reduce public revenues and increase cyclical spending, creating a so-called cyclical deficit. Studies put the sensitivity of the government balance to the business cycle at around 0.5 to 0.6 for France.<sup>16</sup> In the short run, a 1% fall in GDP reduces tax revenue by about 1% (unit elasticity) and has little effect on the level of public expenditure. The deficit-to-GDP

ratio therefore increases by almost the same amount as the expenditure-to-GDP ratio, i.e. by around 0.55 points: this is the impact on the cyclical deficit.

The problem of budgetary consolidation thus arises. In order to stabilise the debt, a positive primary balance must be achieved through a series of budgetary measures that will weigh on growth through multipliers. Therefore, it makes sense to spread these measures over time in order to limit the social costs of consolidation. However, there is a cost to delaying consolidation: as long as the overall primary deficit is positive, the debt-to-GDP ratio will continue to rise. Moreover, there is a risk that private demand will be crowded out by the rise in interest rates induced by the increase in public debt. Indeed, public debt is only partly financed by savings from the rest of the world. It is therefore likely that the increase in the public deficit will partly increase domestic savings (thereby reducing household consumption), raise interest rates  $r$ , reduce investment and worsen the current account balance (this is known as the twin deficits theory).

Analysing this problem unveils a fundamental tension between the cost of debt and the economic cost of consolidation. Since the consolidation effort has a permanent effect on the public deficit, the earlier the effort is made, the greater its impact on the debt. It is therefore always optimal to make a greater effort at the beginning. If  $r = g$ , this effort decreases linearly over time. In addition, the relationship between the cost of debt and the multiplier determines the optimal speed of consolidation. If the cost of debt is low, consolidation can be spread over a large number of years and the debt ratio can rise sharply. On the other hand, if the cost of debt is high or the multipliers are low, we can consolidate quickly.

The optimal consolidation horizon hence depends on the relationship between the cost of debt and the fiscal multiplier. What practical recommendations can be derived from this model? While it is difficult to put a precise figure on the social cost and the multiplier, a few simple considerations show that there is a fairly logical pace of consolidation. In *Focus* no. 108 we present the simulated impact of consolidation at different horizons in our model on the public debt ratio at the end of consolidation, the initial fiscal adjustment and unemployment (the latter is obtained by assuming an unemployment multiplier at the fiscal stimulus of 0.8).

First, it is difficult to achieve an initial fiscal adjustment of more than one point of GDP, as this would almost certainly imply a reduction in public spending in volume terms and an unacceptable impact on unemployment. The model therefore shows that a consolidation horizon of at least 7 years is necessary.

<sup>14</sup> See Auclert A., Ragot X. and Philippon T. (2024): "Fiscal consolidation: an optimal control approach", CAE, *Focus* no. 108, July. More complex versions of this type of model are used to simulate the trajectory of the debt, see OFCE's DebtWatch model.

<sup>15</sup> See for example V. Ramey (2011): "Can Government Purchases Stimulate the Economy?", *Journal of Economic Literature*, and (2019): "Ten Years after the Financial Crisis: What Have We Learned from the Renaissance in Fiscal Research?", *Journal of Economic Perspectives*.

<sup>16</sup> See for example Mourre G., Astarita C., Princen S. (2014): "Adjusting the budget balance for the business cycle: the EU methodology", *European Commission Economic Papers* 536, November.

It is possible to go beyond 7 years. But there are two important points to consider. The first one is the level of debt we are willing to accept. According to our simulation, consolidation over 7 years leads to a debt level of 119% of GDP at the end of consolidation. Each additional year adds about 1 percentage point to the debt. Today, only two European countries have a debt ratio above 120% of GDP: Italy (around 140%) and Greece (150%). Portugal, on the other hand, took strong measures to reduce its debt when it rose above 120%. It would thus be difficult to allow debt to exceed 125% of GDP without risking a sharp rise in interest rates and costly crowding-out effects.

Another important consideration is the European fiscal rules. Since June 2024, France has been subject to an excessive deficit procedure. To meet its obligations under the corrective arm of the Stability and Growth Pact, it must achieve a minimal structural adjustment of 0.5 percentage points per year (Box 2). On the basis of these two criteria, the adjustment horizon should be set at between 7 and 12 years.

In conclusion, fiscal consolidation to reduce the structural deficit should be carried out with stronger fiscal impulses at the beginning of the period, decreasing over time and with an overall pace of consolidation increasing with the cost of debt and decreasing with the size of the multipliers. For instance, consolidation over 7 years implies a primary structural adjustment of 0.8 to 0.9 points of GDP in the first year, declining linearly over the period. If  $r = g$ , this increases the government debt by about 9 points of GDP at the end of the consolidation.

In practice, the government benefits from a windfall effect with lower short-term interest rates on the debt stock and a high debt maturity. In an optimistic scenario (stability programme 2024-2027), this windfall effect could reduce the debt ratio by around 5 points in 2027 compared to our simulation where  $r = g$ . However, the options for possible courses of action offered by this windfall effect are not very numerous and will diminish, which is why consolidation needs to start immediately. It is possible to choose to spread the consolidation over more than 7 years, but going beyond 12 years might come as the expense of credibility and lead to a high level of stabilised debt.

Portugal is an example of a difficult but successful consolidation under the adverse context of the euro area sovereign debt crisis (Box 3). By striving to achieve a primary surplus, Portugal has seen its debt ratio decline rapidly over the past four years.

## Box 2. New European budgetary rules

After being suspended between 2020 and 2023 in response to the impact of the health crisis and the war in Ukraine, the Council of the European Union adopted new budgetary rules for the Union in April 2024.

Budgetary surveillance will henceforth focus on a debt sustainability analysis tool to guide budgetary trajectories. It will also rely on the evolution of public expenditure net of new revenue measures, a new indicator considered more relevant than a deficit rule.

### The preventive branch: an adjustment period that can be extended from 4 to 7 years.

While the thresholds of a public deficit of 3 points of GDP and a public debt of 60 points of GDP remain unchanged, the requirement to reduce excessive public debt over the threshold of 60 points of GDP by one twentieth each year has been replaced by a debt sustainability analysis defining a reference path. According to our information, the path set by the European Commission requires France to adjust by 0.6 points of GDP per year over a period of 7 years. Two "safeguards" have been added.

**A debt safeguard:** From the start of the adjustment period, or from the exit from the excessive deficit procedure, the debt must be reduced by at least 1 point of GDP per year on average for Member States whose debt exceeds 90 points of GDP and by 0.5 points for Member States whose debt is between 60 and 90 points of GDP.

**A deficit safeguard:** the structural deficit may not exceed 1.5 points of GDP. Countries with higher deficits must adjust by at least 0.4 points of GDP per year (or 0.25 points of GDP per year if the adjustment period is extended to 7 years).

### The corrective branch (deficit of more than 3 points of GDP on a permanent basis), consisting of the excessive deficit procedure. Left unchanged by the 2024 reform, it will once again target France, with its public deficit of 5.5 points of GDP in 2023.

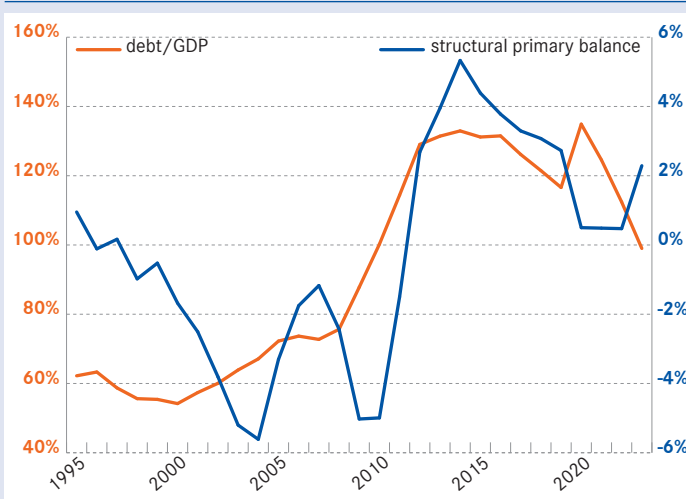
In June, the European Commission recommended the opening of excessive deficit procedures for seven EU countries, including France. In this context, the Commission is calling for a consolidation path with a minimum structural adjustment (reduction in the structural deficit) of 0.5 points of GDP per year.

### Box 3. The period of fiscal consolidation in Portugal

Portugal launched a fiscal consolidation programme in 2011 after years of low growth, rising public debt and large external imbalances. The 2011–2014 programme aimed to restore economic growth and fiscal credibility after a sudden stop in capital flows.

The structural primary deficit was reduced by almost 7 points of GDP, from 3.1 points of GDP in 2006–2010 to a surplus of 3.8 points of GDP on average in the 2014–2019 post-consolidation period. After three years of negative growth from 2009 to 2012, the country experienced positive growth in 2013, which averaged 4.38% per year from 2015 to 2019. Public debt started to decline from 2015. This allowed Portugal to cushion the Covid shock before rapidly reducing the debt-to-GDP ratio to below 100% in 2023.

**Portuguese debt and structural primary balance, 1995–2023**



The authorities increased social protection spending by 1.6 points of GDP between 2010 and 2014, despite the overall reduction in public spending, in order to mitigate the impact on the poverty rate. The Gini coefficient of disposable income remained broadly unchanged during the reform.

The consolidation led to a reduction in public spending on education of almost 1.5 GDP points, but OECD data show that Portugal continued to narrow its educational performance gaps with other EU countries during the programme, thanks to measures such as targeted incentives to improve student performance and greater autonomy for schools in planning teachers' timetables and subjects.

**Source:** IMF (2022): Portugal: Fiscal Policy and Social Outcomes Macroeconomic Stabilisation Programme 2011–2014.

**Graph source:** IMF (2024): *World Economic Outlook*, April.

## Conclusions and recommendations

Our recommendations are based on the previous analysis and cover: long-term management; adjustment over the next 7–12 years; efficiency and equity principle; credibility and governance.

### How much and when?

#### Recommendation 1 (long-term objective).

France's public finances should aim at a primary surplus of around one point of GDP in the medium to long term.

In this first recommendation, we stress that the primary surplus (in terms of its structural component) should be the guiding principle of fiscal policy. This variable allows for the intelligent management of public finances beyond macroeconomic and financial uncertainties. It should therefore obtain support from policymakers. In the long run, all structural reforms that are likely to have a large positive impact on public finances, especially those broadening the tax base, should be considered. This applies, for example, to all measures aimed at increasing the employment rate of young

people, older people or women, three population groups for which France has a significantly lower employment rate than its neighbours.

Our second recommendation relates to the pace of adjustment. The 2023 structural primary deficit of 3.2 points of GDP calls for a primary adjustment of around 4 points of GDP, or €112 billion, which represents a very substantial effort. The optimal timetable suggested by previous analysis is around 7–12 years. An excessively long adjustment period would undermine the credibility of the effort. An excessively short one would be detrimental to growth.

#### Recommendation 2 (speed of adjustment).

The adjustment should be moderate but steady. An adjustment period of around 7 to 12 years is desirable, with a greater initial effort.

Moreover, economic theory calls for a greater initial effort. There are two reasons for this. First, as we have seen in our model, it allows for a quicker change in debt dynamics. Second, and more generally, it makes the political willingness to restore public finances credible. Nevertheless, reviewing public spending is a demanding and time-consuming exercise, especially if we make an effort not to limit it to "chamber" work (see below).



A large number of expert reports and assessments have indeed already identified possible measures, some of which could be adopted in the short term (see Box 4 next page for some examples). However, the return on these measures is not commensurate with the stakes, estimated at around €112 billion over the next 7-12 years. Therefore, additional temporary measures will probably have to be taken, such as temporary tax increases or a general under-indexation of expenditure and tax brackets. As a purely illustrative example, if the indexation of the civil service point (state, regional and hospital), all social benefits in cash and the income tax scale were all frozen in 2025, instead of being revalued in 2024 at the rate of inflation (estimated at 2.5%), this would generate around €20 billion for the public accounts.

**Recommendation 3 (commitment).** Rapidly implement temporary operational measures to achieve tangible results in the short term. At the same time, launch an in-depth review of public spending, with strong political backing, to find sustainable ways to reduce it.

### Expenditure or revenue?

Our economic analysis assesses the overall effort required and its pace, but its composition remains a political choice. The adjustment can be made through revenue increases, expenditure cuts or, more structurally, through any measure raising our growth potential.<sup>17</sup> However, there are three important reasons why consolidation should include a component of expenditure cuts, or rather a slower growth of public expenditure than our national wealth. The first one is that the level of compulsory taxation in France is already high, especially compared to European counterparts. This affects the competitiveness of the country's companies. It also raises the question of tax compliance, especially if the quality of spending is called into question, which we will come back to later. An expenditure-based adjustment would bring us closer to the European average.

The second element relates to the lessons derived from the past experiences of budgetary consolidation: those that have succeeded in restoring the sustainability of public accounts have favoured expenditure cuts.<sup>18</sup> However, the revenue lever should not be completely discarded, as past successful experiences have combined both levers to achieve a substantial recovery of public accounts.

The third factor is the level of public expenditure, which is significantly higher in France than in the rest of Europe (+7.9 points of GDP in 2023 compared to the European average). This is not a problem in itself, as it largely reflects a high level of socialisation, whether in terms of financing pensions or key public services such as education or health. However, despite higher levels of public expenditure, our country does not perform better in many public policies, and in fact rather underperforms.<sup>19</sup> Recent IMF work shows that France is quite far from the efficiency frontier for several public policies.<sup>20</sup>

### How do we go about it?

Experience has shown that a thorough review of public spending is very useful to identify sources of savings, set priorities and improve the quality of spending. The "planning strategy" of reducing all expenditure has the advantage that it can be implemented immediately, but it has its limits in the longer term, as it can lead to decisions that are economically and socially inefficient. In addition, a purely budgetary approach can have perverse effects because only part of the expenditure can be controlled: this is particularly the case for health insurance expenditure (see Box 5). Expenditure reviews have already been carried out in France, but the results have been disappointing.<sup>21</sup> In this respect, it would undoubtedly be wise to draw on best practice in order to create the conditions for success.<sup>22</sup> Lessons learned from foreign experience suggest the following avenues:

- Ensure political support, both from the National Assembly and from the executive (be it the President of the Republic, the Prime Minister or the Minister of Public Accounts). The objective of making savings must be clearly stated
- Cover all public expenditure and not, as has too often been the case in France, a narrow scope
- Integrate these reviews into the annual and multi-annual budgetary processes
- Apply an accountability principle by involving ministries and heads of administrations in order to achieve greater operational efficiency
- To not be reduced to a "chamber" exercise: take the time to explain and discuss

<sup>17</sup> Measures to raise employment rates, for example.

<sup>18</sup> Lorach N., Mareuge C. and Merckling C. (2014): "Réduction des dépenses publiques: les leçons de l'expérience", France Stratégie, July.

<sup>19</sup> See, for example, the annual panorama of public administrations published by the IMF or Gouard C. and F. Lenglard (2019): "Où réduire le poids de la dépense publique?", *Note d'analyse de France stratégie* no. 74 (January).

<sup>20</sup> Teodoru I.R. and R. Vermeulen (2023): "Spending Efficiency and Reforms, France", IMF, *Selected Issues Paper* SIP/2023/014 (January).

<sup>21</sup> See in particular the Cour des Comptes' annual report on the development of public finances (2023).

<sup>22</sup> See for example Doherty L. and A. Sayegh (2022): "How to design and institutionalise spending reviews", *IMF Note* 22/04 (September) or Bacache-Beauvallet M., D. Bureau, F. Giavazzi and X. Ragot (2017): "Quelle stratégie pour les dépenses publiques?", *Les Notes du CAE*, no.43 (July).

## Box 4. A sample of measures with a positive impact on public accounts

The choice of measures to be implemented to provide an immediate fiscal stimulus should follow some simple principles: priority should be given to revenue increases or expenditure cuts in policies that have been shown to be ineffective, have low fiscal multipliers and have little to no impact on the most vulnerable or on households with a high marginal propensity to consume. Many measures tick these boxes and are well documented in numerous evaluation reports. Here is a short, non-exhaustive list of such measures that have been reviewed by the ACE.

### Reorienting apprenticeship support measures to low-skilled young people

While the positive effects of apprenticeships on the labor market integration of low-skilled young people have been demonstrated, their effects on higher-skilled categories are not very significant.<sup>a</sup>

The opening up of the programme to higher education levels (up to the master's level), decided in the wake of the health crisis, has created a real vacuum in higher education.<sup>b</sup> The OFCE estimates that refocusing on the least qualified young people, in the spirit of the 2018 reform, would generate savings of €4 billion magnitude.

### Better targeting of employer contribution payment exemptions

Since 1993, increasingly significant reductions and exemptions from social security contributions have been introduced for low-paid workers. The rate of employer contributions at minimum wage level has fallen from 45% in 1993 to 6.9% in 2024, and these exemptions are granted up to 3.5 minimum wage levels. The total amount of tax relief now exceeds €80 billion.

While the overall impact of these subsidies on low wages is positive for employment, the impact on higher wages is limited and the impact on competitiveness has not been documented.<sup>c</sup> This finding advocates for abolishing the exemption from employer contributions to the family branch for salaries above 2.5 times the minimum wage, in order to concentrate the reduction in contributions on low salaries, which would save around €2 billion.

### Reform of the research tax credit

The French government finances almost 20% of private R&D expenditure through tax incentives such as the research tax credit (CIR), compared to an OECD average of 6%. These tax incentives have an economic rationale, as private R&D generates positive externalities for society. To be fully effective, the CIR must subsidise investments that would not otherwise have been made. However, it mainly benefits large companies. A number of studies have highlighted its effectiveness for very small enterprises (VSEs) and small and medium-sized enterprises (SMEs), while there is no evidence of an effect for intermediate enterprises (IEs) or large enterprises (LSEs).

The reform proposed by the CAE<sup>d</sup> in a Focus would reduce the tax credits currently received by large companies by around €2.5 billion and generate the same amount of additional revenue for the state.

### Eliminating inheritance tax exemptions

After a decline in the second half of the 20th century, inheritance is once again a decisive driver of wealth creation in industrialised countries. Highly concentrated, it is driving a trend towards greater inequality of wealth by birth, to a much greater extent than inequality of income is.

However, the French tax system, which is progressive in its scale, is riddled with exemptions (life insurance, division of property, transfer of family businesses, etc.) for which there is little economic justification. Moreover, these exemptions mainly benefit the largest transfers and significantly reduce the progressivity of the tax at the top of the distribution. An overhaul of the inheritance tax base would be desirable in order to eliminate or reform the main exemptions, which would generate around €9 billion in tax revenue<sup>e</sup>.

<sup>a</sup> See Cahuc P. and M. Ferracci (2014): "Apprenticeships for Employment", *Les Notes du CAE*, no. 19, December.

<sup>b</sup> See OFCE (2023): Policy brief no. 117; see also IPP (2024): "Évaluation du plan '1 jeune, 1 solution'", report no. 51.

<sup>c</sup> See L'Horty Y., Martin P. and Mayer T. (2019): "The French Policy of Payroll Tax Reductions", *Les Notes du CAE*, no. 49, January. The conclusions of the forthcoming report by Antoine Bozio and Etienne Wasmer on the relationship between wages, labour costs and the activity allowance could serve as inspiration.

<sup>d</sup> Aghion P., Chanut N. and Jaravel X. (2022): "Renforcer l'impact du Crédit d'impôt recherche", CAE, *Focus* no. 90, September.

<sup>e</sup> Dherbecourt C., G. Fack, C. Landais and S. Stantcheva (2021): "Rethinking inheritance", *Les Notes du CAE*, no. 69, December.

- the review's conduct should be guided by the principle of "allocative" efficiency: target policies that have the least social value at the margin. In this respect, a "library" classifying, for each euro spent per policy, the

total cost to the public authority and the corresponding social value would be extremely valuable, as it would enable the comparability of public policy evaluations<sup>23</sup>.

<sup>23</sup> The Conseil d'analyse économique has proposed developing such a tool.

### Box 5. The limits of ONDAM budgetary management

While the national health insurance expenditure target (Ondam) is voted on each year as part of the Social Security Financing Act, with the aim of containing health care expenditure, there is no mechanism for containing expenditure on outpatient care.

There are mechanisms to contain ambulatory health expenditure, by diversifying self-employed health professionals' incomes, but they remain very limited in scope. For instance, self-employed professionals are still almost exclusively paid on a fee-for-service basis, a form of remuneration considered inflationary. Finally, medical acts remain reimbursed a posteriori, while the expense dynamics are imperfectly anticipated, let alone controlled, with activity that is imperfectly anticipated and even less controlled.

In this context, the target for ambulatory care is often exceeded, which in the past has led to budgetary efforts being inflicted upon hospitals,<sup>a</sup> thus undermining the Ondam approach. Controlling sickness fund expenditure without controlling outpatient expenditure is an example of poor management of public expenditure, which has put considerable pressure on hospitals at the expense of a fair distribution of budgetary effort.

This fragmentation of the public health expenditure target calls for a unified approach to all this expenditure (municipal, hospital and medico-social), which requires a more comprehensive review of the organisation of health care provision and pricing methods. The CAE has made a number of proposals in this direction.<sup>b</sup>

<sup>a</sup> See in particular Bozio A. and B. Dormont (2016): "Governance of Social Protection: Transparency and Effectiveness", *Les Notes du CAE* no. 28, January.

<sup>b</sup> See Askenazy P., B. Dormont and P-Y. Geoffard (2013): "Towards a More Efficient Health System", *Les Notes du CAE* no. 8, July; and Dormont B., P-Y. Geoffard and J. Tirole (2014): "Redisgning our health insurance", *Les Notes du CAE* no. 12, April.

Credible management is a crucial factor in the success or failure of reforms. Precise instructions of expenditure reviews and political consensus on objectives must be ensured if spending is to be reduced in the long term. Administrations need to be involved by being encouraged to propose and evaluate spending cuts. Parliamentary debate can underpin the decisions with a target framework.

### Review the governance of public finances

Finally, it is essential to reform the governance of public finances, which in France is still too fragmented and too focused on the short term. It is true that the Organic Law of December 2021 introduced a spending target into the Multiannual Public Finance Programming Act (MPFPA) and broadened the remit of the High Council of Public Finance (HCFP). The HCFP now assesses "the realism of public finance forecasts, the respect of public expenditure targets in the light of the multiannual guidelines defined in the public finance programming law and the consistency of the multiannual programming law projects concerning certain sectors of public action (defence, research, etc.) with the public expenditure targets defined in the public finance programming law in force".

However, the annual finance laws still prevail over multiannual programming laws, which are therefore not really binding. Moreover, the Multiannual Public Finance Programming Act (MPFPA) and the stability programme are not necessarily consistent with one another, which significantly reduces their overall credibility. Furthermore, multiannual programming laws are not subject to an in-depth debate in Parliament, nor with representatives of locally elected representatives and

social protection bodies prior to their adoption, which does not allow for their proper appropriation.

In addition, although the HCFP has established its credibility through its ability to issue convincing opinions limiting the optimistic bias of the economic forecasts for the finance bills, its mandate and powers remain narrow compared to those of other European Independent Budgetary Institutions (IBIs). The HCFP does not produce macroeconomic forecasts and only publishes an advisory opinion on the government's economic scenario, without providing any formal validation. It also does not produce public finance forecasts, although it is now more clearly equipped to give an opinion on them. The ability to provide an in-depth assessment of budget projections depends largely on the quality of the information provided by the government and the time available to analyse it. However, the HCFP has only one week to give its opinion, much less than the other European IBIs. The HCFP is not mandated to quantify the costs or budgetary returns of new measures or to assess their economic impact; it is not equipped to produce analyses of the long-term sustainability of public finances and debt, and cannot act on its own motion (only on referral).

This is a real institutional weakness in France, which does not have access to neutral, high-level expertise on public finance projections and on assessing the costs of reforms or new measures. There is also a lack of transparent, overall expertise on the evolution of expenditure based on the determinants specific to each sector (with unchanged policies): with a few exceptions, only the Ministry of Finance has all the information it needs to carry out this exercise. However, this information is essential for the preparation of public finance projections and should be available to political

platforms during election campaigns in order to prepare their programmes.

The preparation (or even evaluation) of macro-financial projections is a process that requires qualified staff and the use of econometric models, which are available in public administrations today. Based on the UK experience with the Office for Budget Responsibility (OBR), and carefully avoiding any administrative redundancy, a forecasting process could be organised within the HCFP, with contributions from the Treasury and other bodies responsible for forecasting public expenditure and revenue, as recommended in an earlier ACE note.<sup>24</sup>

**Recommendation 4 (Governance).** Broaden the remit of the HCFP by making it responsible for assessing the long-term sustainability of public finances, for independent macroeconomic and public finance forecasting, and for evaluating reforms or new policies.

If this *Note* indicates the amounts of expenditure and revenue adjustments required, parliamentary and civil society debates will enable a thorough examination of the implications of each budgetary choice. The identification of reforms and amounts is a political choice that needs to be informed by economic analysis.

<sup>24</sup> Darvas Z., Martin P. and Ragot X. (2018): "Reforming European budgetary rules: simplification, stabilisation and sustainability", *Les Notes du CAE* no. 47, September.



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**Press Contact** Hélène Spoladore

*helene.spoladore@cae-eco.fr*

Ph: +33(0)1 42 75 77 47