

DEBT RETRENCHMENT STRATEGIES AND CONTROL OF PUBLIC SPENDING

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Government debt in major developed countries has reached historically high levels relative to other peacetime periods. According to the Organisation for Economic Cooperation and Development (OECD), by end-2005 general government gross financial liabilities stood at 64.1 per cent of gross domestic product (GDP) in the United States, 77.5 per cent in the euro area and 175.2 per cent in Japan. Extensive use of fiscal policy to regulate economic activity is at the heart of the debt increase.

To prevent government debt dynamics from becoming unsustainable, debt retrenchment strategies must be deployed to boost economic growth potential and build sustainable primary budget surpluses. In many countries, especially in Europe, already-high tax and social security contributions and tax competition mean that fiscal adjustments must come from control of public spending.

A number of countries, including Canada, Spain, Sweden and Finland, have successfully engineered adjustments to deal with major imbalances in their public finances. Their example shows that the consolidation drive must be large in scope and must be based on a significant reduction in the GDP share of current primary expenditure if economic agents are to view it as credible. Also, these efforts must be backed up by structural reforms targeting goods and services markets and the operating procedures of government units.

The consolidation process may be usefully framed by national-level fiscal rules that are designed to control the actions of the public authorities. For example, the reform of the Stability and Growth Pact, which was agreed by the European Council in March 2005, urges Economic and Monetary Union Member States to implement mechanisms to control the growth of public spending. These mechanisms function in conjunction with a shared commitment to fiscal discipline aimed at ensuring compliance with the government deficit and debt thresholds set down in the

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The source of the data used in this paper is the OECD database. Public debt series in the graphs capture the total amount of general government gross financial liabilities at market value (contrary to the Maastricht debt, which is recorded at nominal value). Implicit liabilities such as pensions or public guarantees are not included.

Treaty. This framework, which could potentially be bolstered by a reform of governance mechanisms, also delivers greater transparency to economic stakeholders by ensuring that fiscal rules and stances remain stable regardless of changes in the political situation.

Ultimately, for a debt retrenchment strategy to be successful, there must be a national consensus on the need for such measures. As a result, it is crucial that governments tell their citizens about the challenges associated with fiscal policy. France's Pébereau Report, for example, which was published in December 2005, helped to raise awareness about the dangers of allowing debt to continue heading upwards on the path in place since 1980.

1 Public sector debt retrenchment strategies

While there is a sizeable body of literature on the issue of government debt, it is hard to find a clear empirical or theoretical indication as to the debt level or debt/GDP ratio that signals the onset of a problematic situation. In addition, the methods that many countries used in the past to quickly reduce their debt ratios – monetisation especially – are no longer available today. An analysis of how other countries have tackled the issue offers insight into possible government debt retrenchment strategies.

1.1 Government debt: the virtues of moderation and the risks of excess

There are several arguments in favour of government debt. First, debt acts like a deferred tax (Barro, 1974) and can be used to push back the financing of non-recurring public expenditures (notably those linked to an exogenous shock, such as in wartime). Debt may also be used to ensure that the tax burden associated with a particular spending item is coordinated more closely over time with the benefits that taxpayers will derive from it, potentially over several generations. According to this rationale, debt should finance only high-potential expenditures that are productive over the medium to long term, such as investment in infrastructure, education, research, new technologies and support for innovation. It should not be used to pay for current expenditure.

Under a Keynesian approach, and subject to the limits of this type of policy in an open economy, deficit financing can also be used to prop up the economy during a cyclical downturn, while paying for the stimulus financing after the recovery using the resultant surpluses. If households are non-Ricardian, this approach will have an impact on real economic activity through the standard effects of the Keynesian multiplier. However, this strategy works only if it can be ensured that debt is symmetrically reduced during upswings. In practice, the fiscal policies of highly indebted countries tend to be counter-cyclical during slowdowns but also become more pro-cyclical when the economy picks up again.

Government debt is also inherently a form of redistribution, in terms of the intergenerational transfers that it implies. This principle applies to pension expenditures, for example.

Furthermore, the ability to choose between government debt, which offers low risk and low returns, and private debt, which comes with specific growth- and profit-related risks, is necessary to the smooth functioning of markets. Public debt securities provide a benchmark for market operators because they offer low but set returns and the lowest risk. They are also a benchmark for safe assets and can be used to broaden investors' portfolio diversification options.

There are no economic grounds for eliminating government debt altogether, either from a macroeconomic perspective or from a financial point of view. Yet there is no consensus in the economic literature as to where the optimal level lies. Sustainability indicators, for example, can only be used to identify the conditions required to avoid the risks associated with excessive and growing debt. The sustainable level of debt for a given country depends, among other things, on growth prospects and decisions in terms of the welfare system. Moreover, there is nothing to prove that this level needs to be constant over time. A different or variable sustainable debt level might apply if the demographic structure changes, for example in the event of population ageing. Setting aside the difficulties associated with identifying the optimal level of government debt, the dangers of insufficient debt are counterbalanced by the risks of excessive, unsustainable debt (Wierdsma, 2005). Yet these have emerged as the main risks in many industrialised countries over recent years.

The most frequently talked-about risk is that of a snowball effect, which, when triggered, leads to self-sustaining growth of debt generated by successive deficits in the past and the cumulative momentum of interest expense that they create. In other words, when government debt is high, to satisfy the solvency constraint, GDP growth must be higher than the nominal interest rate (which may be a relatively demanding requirement if the debt burden itself is high), or the primary surplus must be large. If the tax burden is already high, precluding a further increase, the response must be focussed on public spending. But because most public expenditures, like social transfers, wages and pensions, are inherently inflexible, at least in the short term, there is a significant risk that the reduction drive could target spending that is most likely to promote growth. As a result, if not properly calibrated, the measures best suited to countering the snowball effect could crimp potential growth and actually amplify the initial effect.

Excessive debt also makes economic policy less flexible in the short term because the debt burden eats up a larger share of expenditures, hampering the government's ability to stabilise activity in the short term in the event of a recession.

Finally, a debt build-up creates uncertainty on the markets, which speculate as to which strategy the public authorities will ultimately use to pay off the debt. Uncertainty of this sort may prompt creditors to demand a higher risk premium before they will continue lending to general government. In extreme cases, the debt

spiral can lead to a risk of payment default, although this is of course a rare event in industrialised countries. In a less radical outcome, mounting uncertainty about certain government securities may translate into changes in the credit ratings assigned by global rating agencies. A downgrade can shrink the market of buyers of government securities (as in the case of Italian securities, for example, which were downgraded several times).

The question, then, is to find an exit strategy at the point at which the country is already grappling with excessive and growing debt. In theory, governments can call on an array of powerful tools to extricate themselves from such situations. In practice, however, few of these tools can actually be put to effective use under the circumstances.

In the past, the preferred method was monetary financing of the debt through inflation. *Ceteris paribus*, an increase in inflation erodes part of the debt over the medium term and increases seignorage. The real interest rate declines, or even becomes negative, enabling monetisation (monetary creation destined to finance public spending) to absorb a significant portion of the debt. This approach, which France used between the wars, is now ruled out, at least in Europe, where independent central banks are in charge of controlling inflation.

The practice of debt repudiation, which creates a major risk of loss of confidence and credibility, is no longer an option, at least in industrialised countries. Similarly, imposing a one-off tax on income or capital, or allocating non-recurring revenues to debt reduction, are not long-term solutions. Without structural changes in the nature and structure of revenues and expenditures, debt will begin to balloon again, requiring new adjustments.

Active debt management may also play a part in debt reduction by optimising the structure and nature of securities. However, the potential gains are limited and cannot by themselves reverse the cumulative momentum gathered by the debt burden.

The surest way to reduce the debt ratio is definitely to increase economic growth. The problem is that countries may find it extremely difficult to significantly increase their (potential) growth, even in the medium term. Reducing the debt ratio through structural reforms that cut public spending, potentially with transitional costs, appears to be a necessary and/or sufficient condition to stimulate activity. However, the statistical estimates of the link between growth and public finance variables are weak.

Accordingly, tackling primary deficits directly seems to be the method that is most commonly required to reduce government debt. To cut the primary deficit, taxes must be raised or collected more effectively and/or public spending must be reduced, if possible by making them more efficient. However, as mentioned above, this comes with political and economic costs. Public spending that is considered to be productive, like R&D, higher education, support for innovative or high-tech firms and investment in infrastructure, should be maintained. If we take the view that Ricardian effects do not dominate, the government and the population should be

ready to try out a J-type curve where the spending squeeze initially has no visible impact on the debt and may cause a temporary growth slowdown. It is necessary to wait until the deficit reduction generates favourable debt momentum that frees up the flexibility needed for positive growth effects to emerge.

1.2 Root causes of excessive government debt and national debt retrenchment strategies

Since the early 1970s, government debt levels have been on a sustained uptrend that has nothing to do with military conflict or a major economic shock. There are many reasons why the public finances have deteriorated since 1973. First of all, the structure of government spending has undergone radical change, spurred notably by increased demand for interventionism aimed at delivering Keynesian regulation of the economy and organising redistribution between agents. Social spending (transfers linked to healthcare, pensions, low-income support) has gone up far more than spending on state services, like police, defence and justice, has gone down. Moreover, as the scope of the public sector has widened, so current expenditures (public sector employment, wages) have risen (Schuknecht and Tanzi, 2003). Only spending on investment, subsidies and capital transfers has fallen, even as new needs have emerged that might have caused them to increase, e.g. subsidies for innovative companies, environmental protection, research and development, education and infrastructure. Initially, periods of unexpected high inflation meant that these structural imbalances were painless from a fiscal perspective. Low or even negative real interest rates helped to contain the increase in debt. From the early 1980s onwards, however, the latent imbalances were revealed as inflation was brought under control (leading to more accurate expectations) and reduced, as welfare systems were expanded and extended to achieve universal coverage, and as growth slowed markedly. These expenditures are often viewed as social «acquis» that exist independently of economic conditions, which means that cutting them comes with high political and social costs. In addition, even though the tax burden has become heavier (an increase that has nonetheless been limited by tax competition), government revenues have suffered owing to the slow increase in tax bases and have been insufficient to offset these changes. So while industrialised countries may have started out from fairly similar situations in the 1970s, today they find themselves in sharply contrasting budget positions.

1.2.1 Lessons learned from the experiences of other countries

Faced with repeated and growing government deficits, several countries, including Canada, Spain, Sweden and Belgium, responded by implementing large-scale reforms to increase or re-establish sustainable primary surpluses. Some began this process in the mid-1980s, while others started in the early 1990s. A number of other countries, including France, Germany and Greece, have not (so far) undertaken a major fiscal consolidation drive (see Figure 1, Table 1). A few representative

Table 1
Comparing France against Examples of Successful Fiscal Consolidation

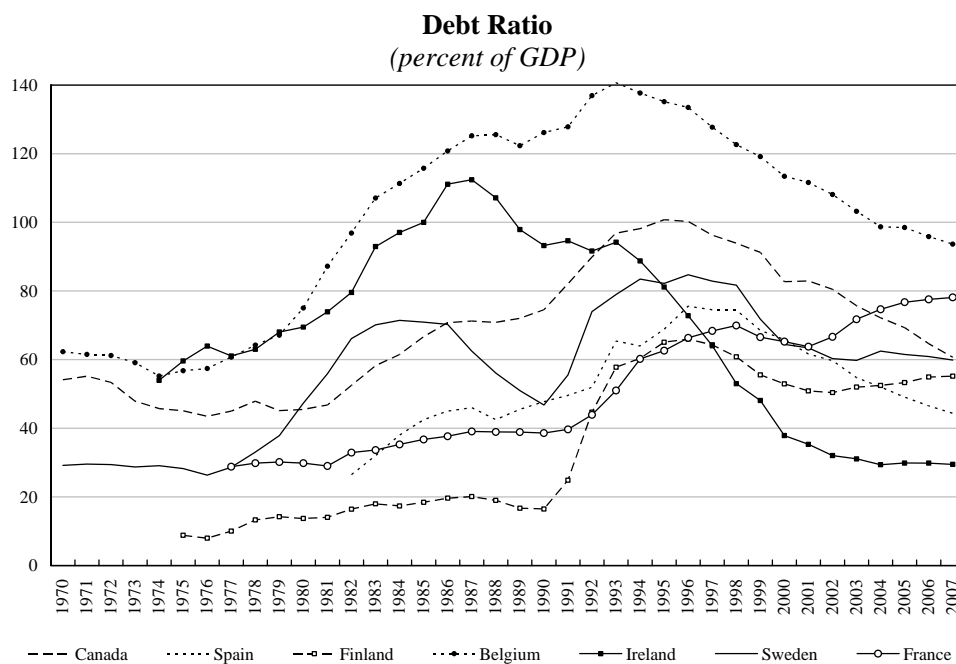
Country	Debt Ratio Peaked in	Peak Debt Ratio (a)	Difference between Peak Debt Ratio and 2005 Peak	Spending Ratio Peaked in	Peak Spending Ratio	Difference between Peak Spending Ratio and 2005 Peak	Largest Deficit Recorded in	Level of Maximum Deficit	General Government Balance in 2005	Adjustment Began in	Potential Output after Adjustment
Belgium	1993	140.7	42.4	1983	62.0	11.9	1981	-15.3	-0.1	1983	=
Canada	1995	100.8	31.5	1992	53.3	14	1992	-9.1	1.7	1993	>
Spain	1996	75.6	25.2	1993	48.6	10.4	1993	-6.9	1.1	1994	=
Sweden	1996	84.4	25.1	1993	72.4	16.0	1993	-11.3	2.7	1994	>
Finland	1996	66.0	17.4	1993	63.6	12.8	1993	-7.2	2.4	1993	>
France	2005	76.5	0	1996	54.5	0.1	1993	-5.8	-2.9	?	n.a.

n.a.: not available.

(a) As indicated in the footnote on the first page, this refers to debt not within the meaning of the Maastricht Treaty, but according to national accounting rules.

Source: OECD, Economic Outlook, No. 79, June 2006, for statistical data.

Figure 1



examples will help to illustrate the essential ingredients for successful fiscal consolidation.

Canada: an exhaustive audit of public spending

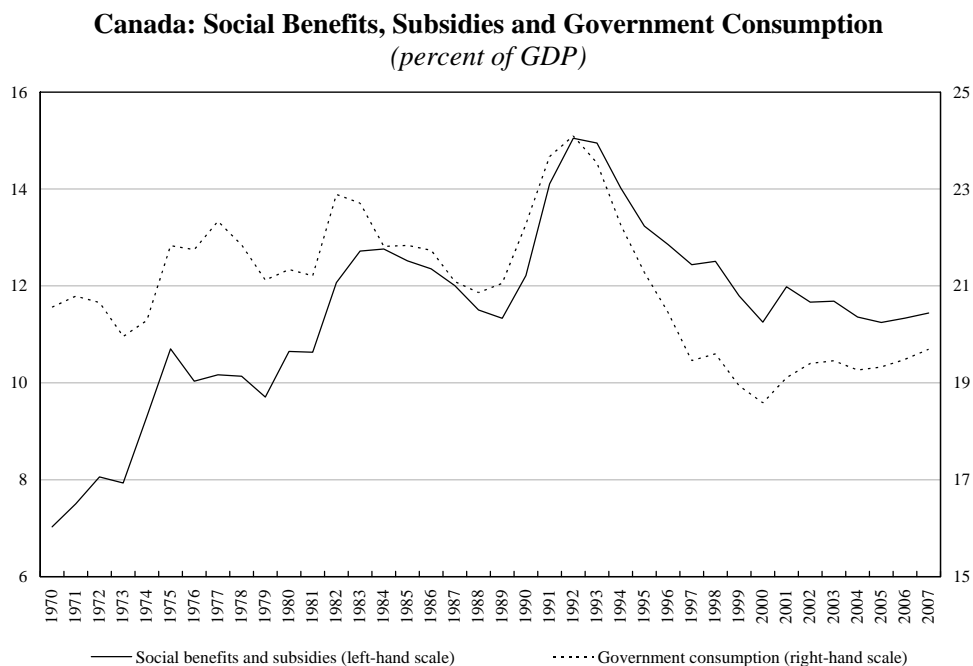
As it entered the 1990s, Canada had to contend with a major crisis that threw the country's fiscal imbalances – which had remained hidden until then – into sharp relief.

Total debt exceeded 100 per cent of GDP in 1995, with federal finances accounting for three-quarters of this amount. The structure and level of public spending proved unsustainable in a setting of flaccid growth and high interest rates. Canadians and provincial governments could see the link between persistently high deficits, the level of interest rates and an inevitable increase in the tax burden in the near future. Accordingly, extensive reforms were introduced starting in 1993, with the enforcement of the 1992 Fiscal Spending Control Act. The reforms were centred on three main strategic priorities. First, to set a reasonable but firm medium-term target for the government deficit. This was deemed a more effective approach than aiming for a zero deficit further out. Second, to slash public spending and keep nominal growth within the set limits. A huge audit was carried out to pinpoint efficient spending and identify sectors where productivity gains were possible as well as those where spending was unwarranted. This exhaustive analysis took six months. Spending was subsequently reduced by some 20 per cent from 1994 levels over three years. Six criteria were used to select authorised public spending: the public interest of the spending programme, the programme's effectiveness, the programme's contribution to the government's state duties, the ability of the provinces to take the place of the federal government, the ability of taxpayers to provide financing, and the availability of alternative private services. Finally, the third priority was to get economic stakeholders behind the reforms. This was achieved through large-scale pre-budget consultations in the public sector.

The budget cuts, which amounted to around 4 points of GDP between 1993 and 1995, affected all spending categories, particularly provincial transfers and social benefits, especially unemployment and health insurance. The public sector workforce was reduced by 15 per cent, *i.e.* 60,000 workers, and public sector wages were frozen for three years. Some business subsidies were cut by 60 per cent, which, in the case of some ministries, including industry and transport, resulted in a reduction in spending in absolute terms and not just a slower rate of increase (see Figure 2).

Labour market reforms were pushed through to create added flexibility and improve training opportunities. The unemployment insurance system was modified to encourage people to take jobs. In addition, the Canadian dollar lost ground against its US counterpart, and this, coupled with the strong American economy, also proved beneficial. The increase in external trade initially offset the adjustment's impact on GDP growth. It then simulated growth, which remained extremely high until the end of the 1990s.

Figure 2



Aside from the public spending measures, a key factor in Canada's success seems to have been strong support for the strategy among private agents. This was possible only because the steps taken were seen as relatively justified and fair (thanks to the audit) and consistent with efforts to restore growth and employment in the medium term. If primary spending had not been adjusted, Canada's debt ratio would have reached, *ceteris paribus*, around 140 per cent today (see Figure 3).

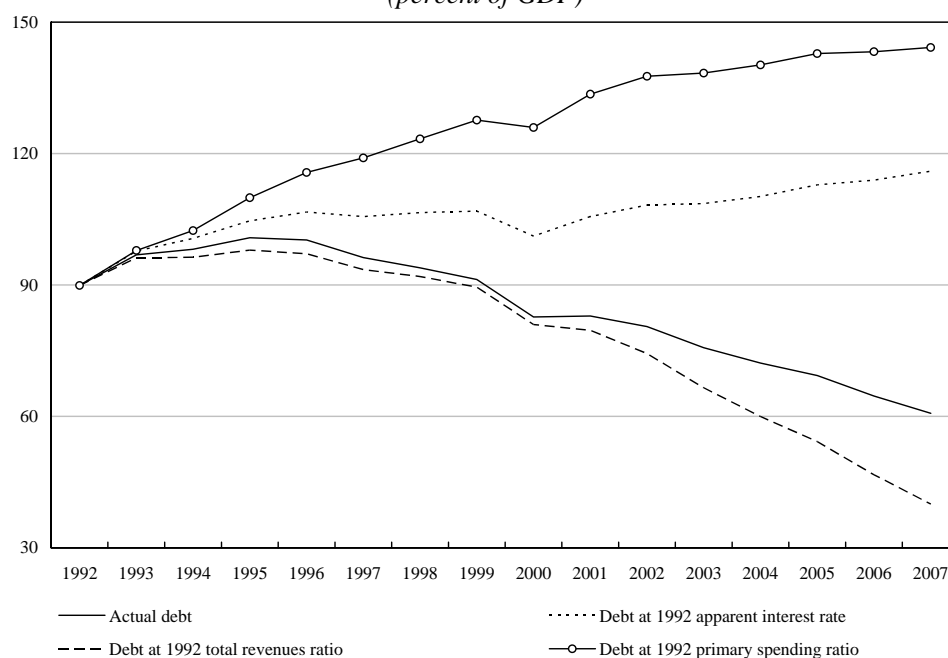
In fact, by getting the public finances back on an even keel, against a backdrop of falling interest rates, Canada was able to bring the total debt ratio down from about 100 per cent in 1993 to around 70 per cent in 2005. Canada is often held up as the best example of a successful fiscal adjustment, achieved by combining a complete overhaul of public spending, a profound reform of fiscal institutions, plus other structural reforms. That said, with its federal government, open competition-focussed economy, and independent monetary and foreign exchange policies, Canada has specific qualities that set it apart from European countries.

Spain: taking advantage of favourable conditions

Spain's public spending has risen markedly since the 1970s, mainly reflecting the increased size of the country's welfare systems. Large deficits built up despite an

Figure 3

Canada: Debt Dynamics under Different Assumptions
(percent of GDP)



Each curve is computed by locking one of the parameters and inputting the others at their actual values. For example, when the primary spending ratio is locked at its 1992 value, the values for interest payments, the total revenues/GDP ratio and the GDP growth rate are the actual values for these parameters.

increase in the tax burden, which was accentuated by initial efforts at fiscal consolidation in the 1980s. However, monetisation successfully prevented debt from exploding until the deep recession in the early 1990s. Spain was then once again confronted with an unsustainable deterioration in its public finances.

Spain decided to implement large-scale fiscal consolidation, both to create a virtuous circle of high growth and moderate inflation, and to meet the Maastricht criteria in 1997. The measures included in the 1994 reform were designed to maximise the adjustment's credibility (composition of spending, return to fiscal discipline based on a solid institutional framework, steps to combat tax fraud) and quickly reap the benefits in terms of growth and jobs. The actual fiscal adjustments were sizeable, at 3 points of GDP over two years, and got support from the outset from robust economic growth (far outpacing the expansion recorded by the euro area, even though the zone was in a cyclical upswing) and the decline in nominal interest rates. This made it possible to quickly slash current expenditures (social transfers, especially unemployment benefits, the public sector wage bill and subsidies) without an overly pronounced short-term impact on growth.

At the same time, Spain implemented other structural reforms, to pensions, company tax (1995) and individual income tax (1998), in a bid to simplify the tax system and increase incentives while augmenting budgetary elasticities. It also pushed through labour market reforms that introduced added liberalisation and flexibility, particularly from 1997 onwards. Finally, Spain benefited at the beginning of the fiscal consolidation process from non-recurring revenues linked to public sector reforms (privatisations in the energy and telecommunications sectors) and large European structural fund payments.

If Spain had not adjusted its primary spending from 1994 onwards, its debt ratio would now be close to 110 per cent of GDP. However, the actual reduction in the debt ratio, which was cut from 65 per cent in 1993 to around 50 per cent in 2005, would have been greater if a portion of the gains had not been directed towards the decline in tax revenues after 1997, which was linked, among other things, to sweeping decentralisation of tax and fiscal responsibilities. The Budget Stability Act voted in 2003 is intended to provide an institutional guarantee that consolidation efforts will continue and to prevent local public finances from slipping as they have in Canada.

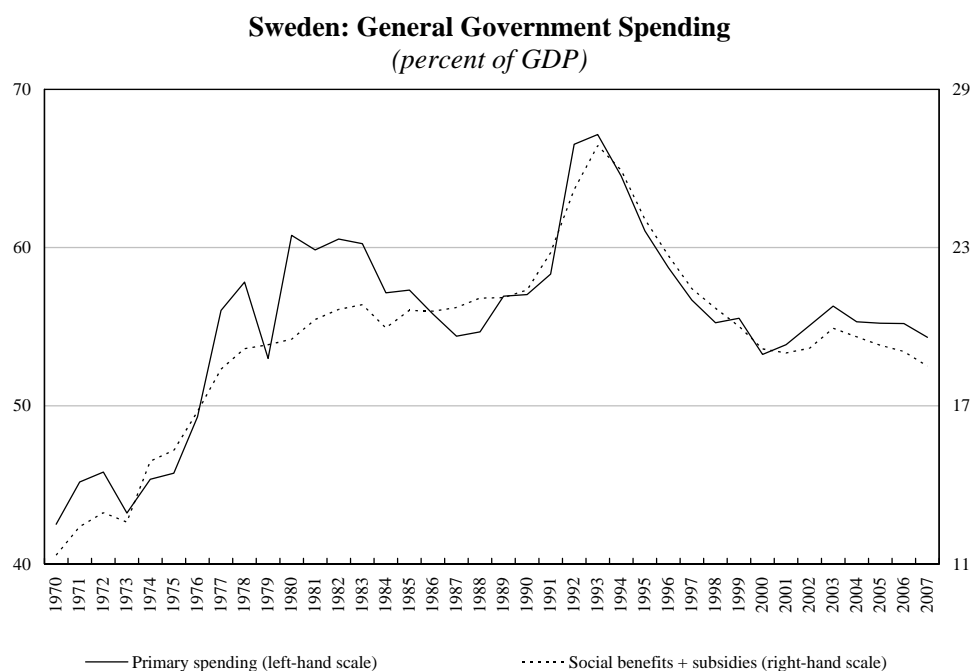
Sweden: vast institutional reform and streamlined fiscal procedures

In the early 1990s, Sweden was confronted with a deep-seated banking crisis combined with a serious economic recession. This situation coincided with growth in government deficits, the debt ratio and unemployment. In 1994, the government reacted by undertaking a massive consolidation drive, which it backed up with reforms to fiscal procedures and institutions. As elsewhere, the fiscal adjustment was focussed on cutting spending (by 16 points of GDP since 1994), chiefly social transfers, subsidies and government consumption (decline in public sector employment) (see Figure 4). The tax burden remained heavy over the same period, even increasing temporarily with the introduction of solidarity surtax, while a privatisation programme in the telecommunications sector helped to reduce the debt. However, it was the transformation of fiscal institutions and procedures that ensured that these measures had a lasting effect.

The aim was to reduce the size of the public sector, while raising efficiency and oversight. Accordingly, the public sector was reformed to form fewer ministries (13) and three hundred public or public-private agencies that account for 99 per cent of civil servants.

The reforms to fiscal procedures included caps for nominal primary spending. Spending is set top-down, meaning that the Riksdag establishes an overall budget that is then divided between different programmes, with no allowance for exceeding the set limits. Any additional spending programmes must be funded through cuts in other areas. Priority is placed on productive spending, like education, some healthcare services and child-related services, rather than on corrective spending, such as social transfers. The budget preparation process, which culminates in a vote

Figure 4



on the Budget Act, has been simplified and gives Parliament a greater role, including in setting three-year targets. Finally, fiscal discipline is anchored within the framework of a medium-term objective of a budget surplus of 2 per cent of GDP. All in all, the Swedish strategy, which got a lift when GDP swiftly began expanding again at a robust pace on the back of soaring exports, reduced the debt ratio from around 85 per cent of GDP in 1996 to around 60 per cent in 2005. Furthermore, the budget's sensitivity to economic activity, which used to be highly pronounced, was reduced, thus limiting forecasting errors and helping the public finances to stabilise.

Finland: the fiscal adjustment did not destroy the foundations of the social security system, but reduced the system's scope

Finland was in the same crisis situation as Sweden in the early 1990s. The government responded by seeking to use structural reforms to tackle problems that were seen as chiefly structural in nature, in an effort to provide lasting protection against fiscal slippage and to prepare for the impact of a greying population. Finland introduced fiscal rules for public spending and, like Sweden, radically overhauled its fiscal institutions. The fiscal adjustment was accompanied by other measures, including pension, labour market and banking sector reforms. Finland also accelerated the pace of consolidation by beginning tax reforms in 1993. The

founding principles of the welfare system were not altered in the reform process: efforts to build social consensus and centralised collective bargaining remain core components. However, to maintain the standard of social services while reducing costs, steps were taken to reorganise programmes and make them more efficient. Even so, Finland has not solved the problem posed by the transfer of fiscal slippage at the central government level to local authorities, which have the freedom to raise income tax if faced with new charges or obligations. Moreover, the scope of welfare services that the government will continue to finance as the population ages has yet to be determined. To ensure fiscal sustainability, some programmes will probably be run by the private sector. However, the overall outcome of consolidation has been positive, because in 2005, Finland's debt ratio stood at around 50 per cent, compared with 66 per cent in 1996.

1.2.2 Necessary (though insufficient) conditions for successful fiscal adjustment

Although the specifics of national situations are complex, an analysis of the main features of fiscal reforms that have enabled countries to scale back their debt ratios reveals several shared factors that look to be necessary to the success of such undertakings.

Broader context of the adjustment

- Long-term fiscal imbalances are generally structural in origin and essentially stem from an inability to easily curb rising, uncontrolled growth in public spending. The solution lies with structural responses and with permanent improvements to public finances, rather than with cyclical measures.
- A fiscal adjustment will be less costly from a social and political viewpoint if undertaken when macroeconomic conditions are favourable. In other words, countries must take advantage of good times and low interest rates to carry out the necessary structural reforms.

Adjustment measures and implementation

- Successful adjustments are rooted in long-term control of public spending rather than an increase in statutory charges.
- In most cases, spending cuts are concentrated on social transfers, subsidies and the public sector wage bill. The government has to identify priority spending, which is allowed to increase, while curbing other expenditures. Reforms are accompanied by efforts to identify productivity gains in the public sector and organise institutions more effectively, for example by setting up specialised agencies, transferring staff, introducing performance-linked pay, enhancing oversight to make sure that targets are met, deploying new recruiting techniques, and shifting the line between public and private spending. Most consolidation

programmes are geared towards sharing the cost of the adjustment across all private agents to build broad-based support.

- The fiscal adjustment typically forms part of a strategy aimed at making break with the past. Global, large-scale reforms are introduced in a single stroke to demonstrate the consistency of the overall project, build credibility and encourage private agents to prepare for a future decline in the tax burden.
- Successful attempts at consolidation feature a detailed programme and firm political commitments, including short and/or medium-term fiscal objectives, spending targets or caps, and strict rules of conduct, particularly for the allocation of non-recurring or unexpected revenues, greater input from Parliament and increased accountability for public sector management.
- These adjustments seek to bring the automatic stabilisers into play in a symmetrical way. In other words, they prevent tax and social security contributions from being reduced or new unfunded expenses from being incurred during a cyclical upswing until such time as the public finances are back on a sustainable trajectory.

Support for and communication about the fiscal adjustment

- The government endeavours to make the adjustment processes as transparent and understandable as possible to avoid undesirable market responses and lack of support from the public and opinion leaders.
- The reforms are set within a legal framework, making them better able to stand up to changes of government, political disputes, and pressure from social groups that refuse to give up their advantages or benefits.
- Fiscal adjustments are accompanied by other structural reforms, mainly aimed at making the labour market more flexible, reducing distortions and complexity in the tax system and modifying the pension system. Structural reforms provide support for one another, making the case for a raft of large-scale reforms rather than scattered measures over a long period (Bassanini and Duval, 2006).

Most countries that have successfully consolidated their public finances do not seem to have suffered in terms of their medium-term macroeconomic balance and growth. On the contrary, though structural difficulties may persist and fiscal imbalances may re-emerge, Ireland, Canada, Sweden, Finland and, to a lesser extent, Spain, have, through structural reforms, raised potential output and sharply reduced their unemployment rate.

In France, debt within the meaning of the Maastricht Treaty reached almost 67 per cent of GDP in 2005 and on its current path could exceed 100 per cent in 2015 according to the most reasonable projections. The trajectory of the debt ratio is therefore a concern – one that was recently highlighted by the Pébureau Report. In France today, monetary policy is centralised at the European level, interest rates are historically low, the economy is growing at a moderate pace, tax and social security contributions are high, and public spending, which already stands at sustained levels, is under strong upward pressure from population ageing. Since it is harder to make

adjustments when big changes are needed, France should learn from the successes of other countries and begin swiftly taking steps to reduce government debt and implement the necessary reforms.

2 Control of public spending and fiscal rules

To avoid the risk of a trend increase in the government debt burden, the new approach used today in most developed countries is based on curbing the use of fiscal policy and especially public spending. Instead, the public finances should be managed from a medium-term perspective to ensure that fiscal balance is maintained over the entire economic cycle. In several European countries, there is a clear link between an uncontrolled increase in public spending and persistent large structural government deficits.

2.1 Patterns in public spending in Europe since 1972

In Europe, the GDP share of public spending is historically far higher than in other developed countries, which essentially reflects the fact that general government has a broader scope of activities than in the United States and Japan.

2.1.1 Analysing approaches to public spending

Until the early 1980s, the GDP share of total expenditures rose sharply in all European countries except the UK, with the increase being more rapid in catch-up countries like Spain.

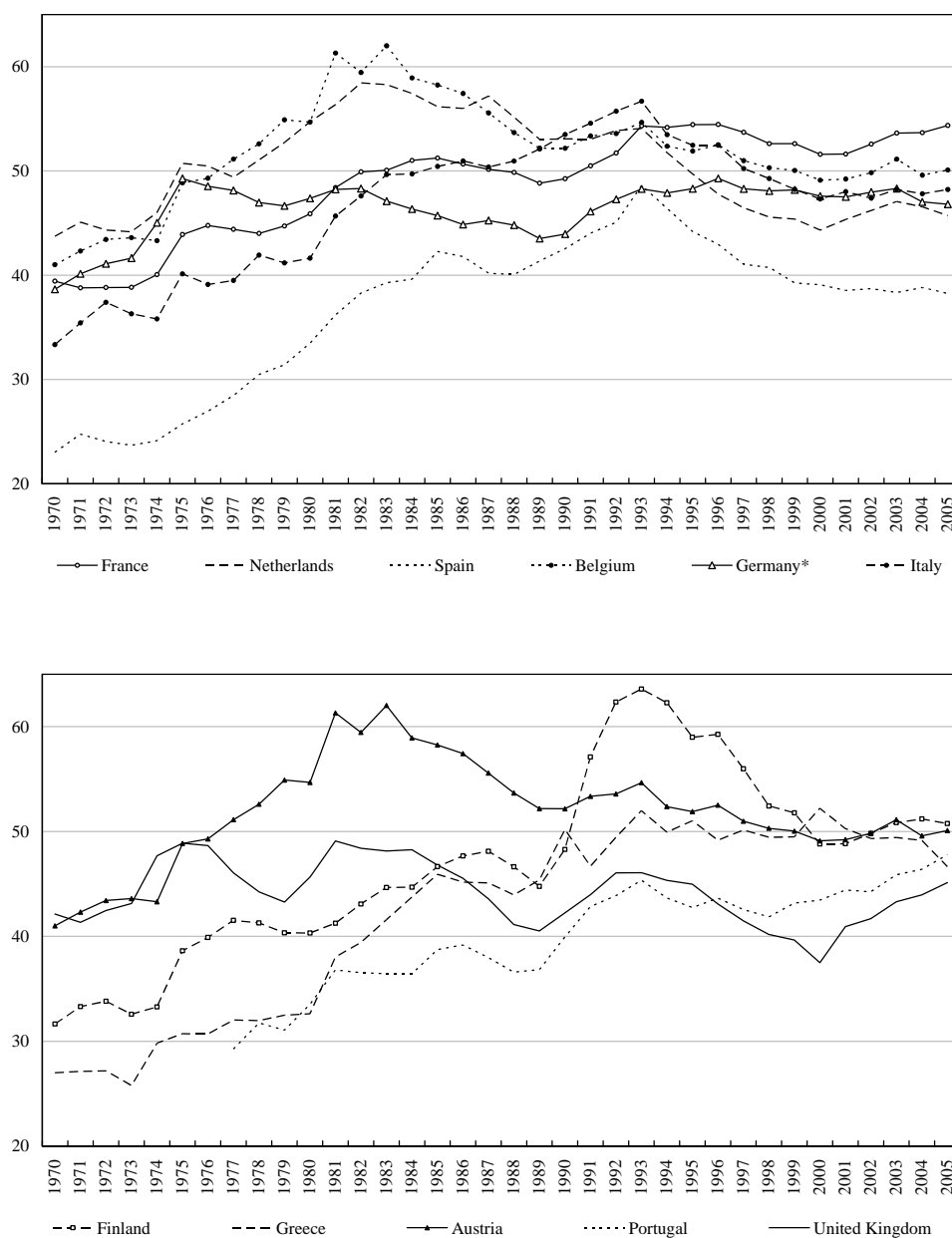
The trend then stalled in the 1980s in Germany, Belgium and the Netherlands and after 1993 in most other countries (see Figure 5). Some countries, including Spain, Ireland and the Scandinavian countries, actually managed to significantly reduce the GDP share of their public spending.

The trend break seen from the early 1980s in all developed countries except Japan primarily reflects lessened use of discretionary fiscal policies. Several other factors also played a part, including the impact of lower interest rates on debt servicing, reduced corporate subsidies and military budget cuts. European countries were also affected by efforts to get ready for Monetary Union, which forced Member States to conduct fiscal consolidation policies from the start of the 1990s, typically in the shape of reduced public spending.

The way that European countries approach public spending can be analysed by looking at the cumulative change in the nominal primary public spending ratio since 1972. This date is used as the reference point because it marks a time when growth was high and general government deficits were small or even inexistent in all the countries under examination. Primary spending is considered rather than total

Figure 5

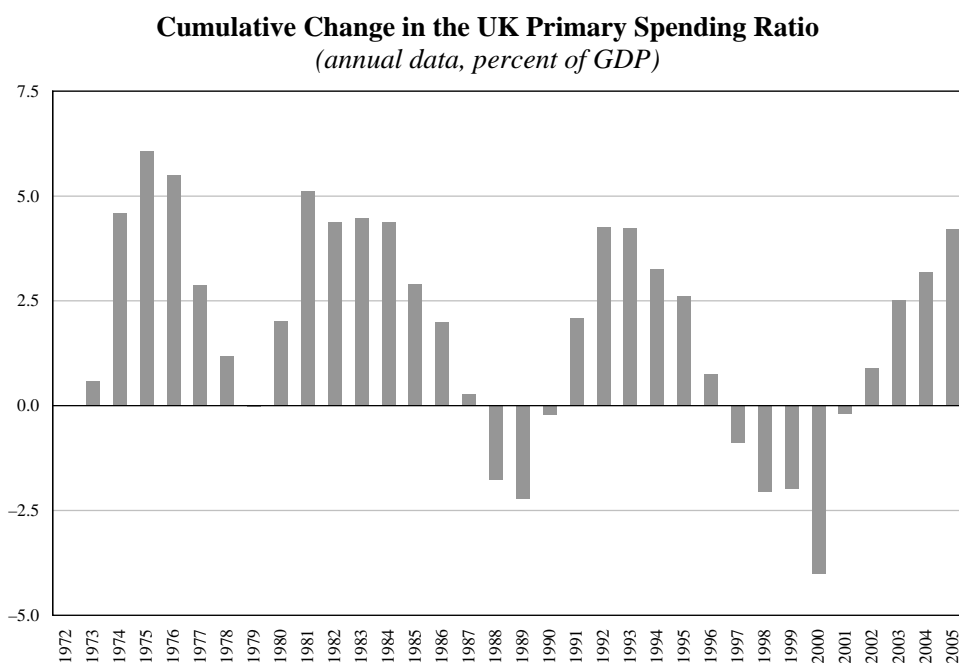
Total Spending Ratios in Several European Countries
(annual data, percent of GDP)



* Series backcast based on the former FRG series.

Source: OECD.

Figure 6



Example: in 1982, the UK primary spending ratio was four points higher than its 1972 level.
Source: OECD

expenditures because governments have little control over changes in the debt burden, which depends on the stock of debt and the level of interest rates.

UK: the odd one out

UK primary spending increased from 38.8 per cent to 43 per cent of GDP between 1972 and 2005. Spending averaged 40.6 per cent and thus reflected relative long-run stability. Figure 6 reveals that the UK managed to increase primary public spending on average at the same pace as GDP, while making small short-run adjustments to keep pace with the economic cycle, with increased spending during cyclical troughs and cuts during peaks.

The UK thus deployed public spending counter-cyclically, going beyond the effects of the automatic stabilisers (OECD, 2003). This discretionary policy, though, did not cause a trend increase in the GDP share of public spending because the UK made spending cuts that matched earlier increases. However, the UK's case clearly differs from that of other European countries, where the flexibility of public spending is limited by the features of the welfare system and rules protecting the public sector.

A far more linear progression in other European countries

At least until the beginning of the 1980s, the GDP share of primary spending increased steadily in all other European Union (EU) countries, albeit to varying degrees. The ratio increased by more than 20 points in Spain, Sweden and Finland between 1972 and the early 1990s. Over the same period, the ratio increased by around 10 points in France and Italy, by 7 points in the Netherlands and by less than 5 points in Germany.

Patterns became more diverse from the mid-1980s onwards. Several countries managed to trim their primary spending ratios by at least five points of GDP over several years, starting with Ireland, Belgium, the Netherlands and Denmark, followed at the beginning of the 1990s by Sweden, Finland, Italy, Spain and Austria. Ireland and the Netherlands then achieved further reductions. Germany was also part of this group. However, after radically cutting its primary spending in the 1980s, Germany saw the trend subsequently reverse as a result of reunification.

After this adjustment phase, there were fairly large cross-country differences in primary spending performance: in Denmark and Italy, spending resumed its uptrend, completely cancelling out the previous consolidation drive; expenditures stabilised in Spain, and continued falling in other countries, including Ireland, the only EU country whose 2005 primary spending ratio was lower than the 1972 ratio.

The other countries have not experienced a sharp decline in primary spending. Over the long run, their ratios have steadily increased by stages owing to counter-cyclical fiscal policies that are more pronounced during cyclical troughs than during more clement periods, making it impossible to reabsorb the additional spending incurred during the downswing. The trend is especially marked in Greece and Portugal. France (see Figure 7) can also be included in this group, although primary spending seems to have more or less stabilised since 1993.

2.1.2 The link between spending growth and excessive deficits

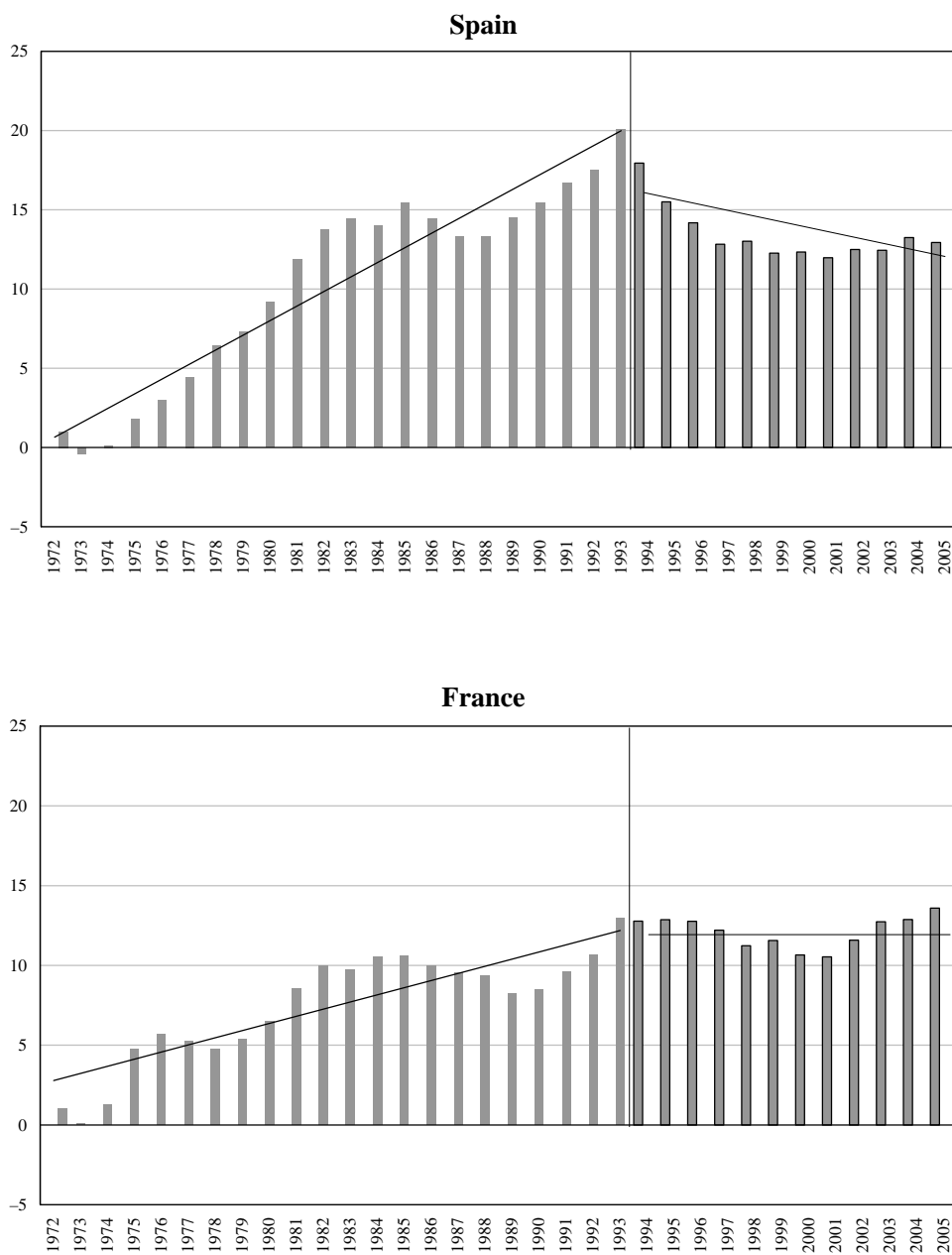
Primary spending trends have differed sharply across countries since 1993, the year that marked the start of preparations for entry into Monetary Union. The overall downtrend masks the fact that some countries have either maintained or increased spending levels (see Table 2).

Under the Monetary Union rules, convergence is not required in primary spending levels provided Member States maintain sustainable fiscal policies. Aside from the fact that the scope of government activities varies from country to country, the continued existence of sizeable divergences can be traced back to a number of factors:

- different budgetary positions when preparations for Monetary Union got underway, which dictated the scale of the necessary deficit reduction programmes;

Figure 7

Cumulative Change in Primary Spending Ratio
(annual data, percent of GDP)



Source: OECD.

Table 2

Primary Spending (excluding Universal Mobile Telecommunications Systems – UMTS) in EU-15 Countries
(percent of GDP)

Country	1993	2005	Change
Germany	45.1	44.0	-1.1
Austria	52.1	46.7	-5.4
Belgium	43.9	45.6	1.7
Denmark	53.5	50.2	-3.3
Spain	43.6	36.4	-7.2
Finland	59.2	49.1	-10.1
France	51.0	51.7	0.7
Greece	39.4	41.8	2.4
Ireland	38.2	33.4	-4.8
Italy	43.6	43.5	-0.1
Luxembourg	39.3	43.1	3.8
The Netherlands	48.3	43.3	-5.0
Portugal	38.0	45.1	7.1
UK	43.0	43.0	0.0
Sweden	66.6	54.5	-12.1
Euro area	46.1	44.6	-1.5

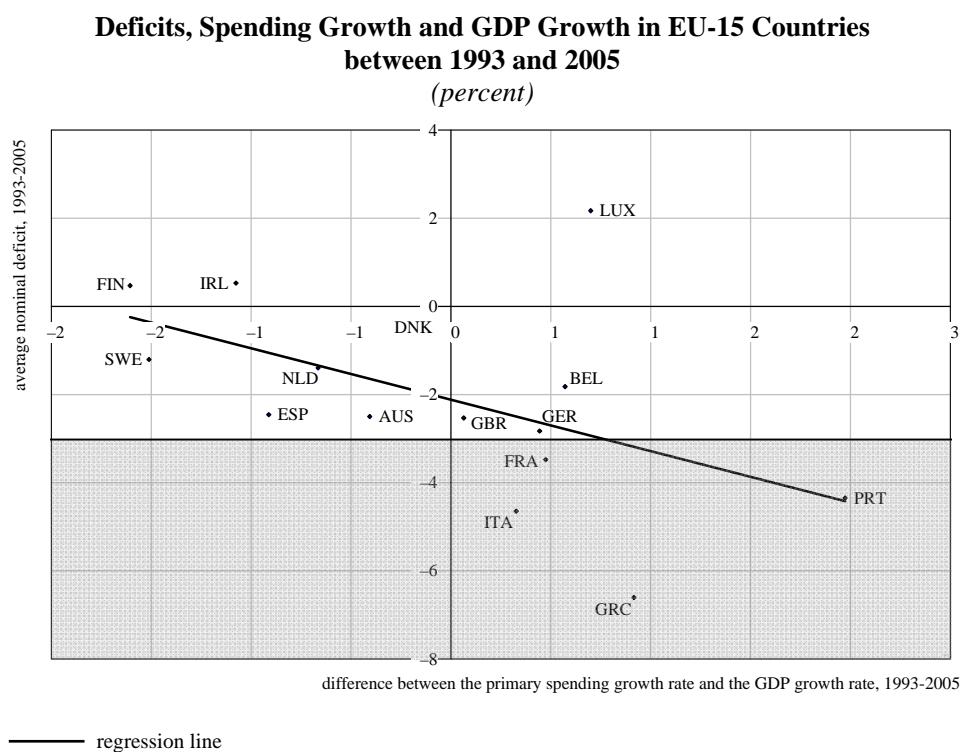
Source: OECD.

- different fiscal policy choices from 1993. While some countries consolidated their public finances entirely by cutting spending, other countries concentrated on increasing revenues.

However, stabilising the primary spending ratio appears to be a decisive factor in preventing permanent deficits from taking shape.

This link is illustrated in Figure 8, which compares average growth in primary public spending in each of the EU-15 countries over the 1993-2004 period, measured in terms of the difference relative to GDP growth, with the average general government balance. The presence of a high general government deficit is correlated with “excessive” growth in public spending, in the sense that these expenditures increased more quickly than GDP on average over the period.

Figure 8



NB: Countries in the shaded zone recorded an average deficit of more than 3 per cent of GDP between 1993 and 2005.

Source: OECD.

There may be justification for allowing public spending to temporarily grow more rapidly than national wealth in certain instances, e.g. if the country is playing economic catch-up, if new investments are being financed or if welfare services are being enhanced. But a long-lasting faster rate is a sign that the excess public spending is insufficiently productive because it has failed to trigger a corresponding increase in GDP. In the absence of corrective measures, countries must choose between letting the deficit widen or increasing statutory charges, two options that both have an adverse impact on longer-term growth.

2.1.3 Which spending items are responsible?

An examination of the make-up of primary spending reveals that two key items are responsible for the long-run uptrend:

- in 2005, social benefits in cash (pensions, unemployment) accounted for around 18 per cent of GDP in France and Italy and 13 per cent in the UK. In 1972, the

same item accounted for around 12 per cent in France and Italy and 9 per cent in the UK. The trend growth in these benefits is attributable in particular to extended welfare coverage and the structural impact of population ageing;

- government consumption is an even bigger public spending item, amounting to 24 per cent of GDP in France and around 21 per cent in the UK and Italy in 2005. This item has increased considerably in all three countries since 1972, when it accounted for around 18 per cent of GDP. The main components of government consumption are intermediate consumption, social benefits in kind (essentially healthcare spending) and the public sector wage bill. This last component has grown considerably, reflecting the broadened scope of general government activities, as well as the effects of 30 years of policies to fight unemployment, which in some countries have included increased public sector employment.

These two spending items are hard to reduce in the short term and account for four-fifths of primary spending in the three countries. Their share of total spending has grown from 3 to 5 points since 1972. Conversely, subsidies and public investment, which are usually more productive but can be fairly easily adjusted from one year to the next, have contracted sharply since the 1970s to the point that they now account for a small share of total primary spending: 9 per cent in France, 7.6 per cent in Italy and 6 per cent in the UK in 2005, compared with around 15 per cent of spending in 1972. While the decline primarily reflects the overall trend towards deregulation and privatisation, many countries have focussed on consolidating spending on government programmes instead of cutting current spending. The risk with this short-term strategy, however, is that the quality of public infrastructure could deteriorate, adversely affecting the economy's growth potential.

An analysis of the countries that managed to significantly reduce their primary spending ratios (*i.e.* by at least five points of GDP) reveals that, for the most part, they concentrated on current spending. Table 3 compares 2005 primary spending ratio with the maximum reached over the 1972-2005 period and decomposes the adjustment into different spending items.

In six of the seven countries, spending on government consumption and social benefits accounted for at least 50 per cent of the adjustment in primary spending, with the proportion rising to almost 100 per cent in the Netherlands. Only in Belgium and Austria did cutting public investment account for a significant share of consolidation efforts. The Other Spending item, which includes subsidies and capital transfers paid by general government, played a major role in Ireland and Sweden only.

2.2 *Public spending rules: why they are useful, and putting them into practice*

After discussing the theoretical value of fiscal rules for public spending and the various parameters needed for such systems to function properly, we will briefly review the development of this type of mechanism within the European setting.

Table 3

**Decomposition of the Reduction in the Primary Spending Ratio
in Selected EU-15 Countries**
(percent of GDP)

Country	Peak Year Maximum	Change/2005	Government Consumption	Benefits in Cash	GFCF	Other Spending
Ireland	1982	15.4	3.9	3.8	1.0	6.7
Sweden	1993	12.2	1.9	4.7	0.8	4.8
Finland	1992	10.7	2.7	5.5	0.7	1.8
Netherlands	1982	10.4	0.9	8.2	0.4	0.9
Belgium	1981	7.6	0.5	2.0	2.8	2.3
Spain	1993	7.1	0.9	3.1	0.7	2.4
Austria	1995	5.4	2.0	0.8	1.9	0.7

Source: OECD.

2.2.1 Why use fiscal rules to formalise control of spending?

Making a long-term promise of fiscal discipline to economic agents

Governments are supposed to control public spending much more effectively than public revenues because the former are dependent only to a small degree on the economic cycle. Yet the deficit-bias of governments manifests itself most commonly in an extra-spending bias. This type of approach can be chiefly attributed to a fiscal illusion: individuals underestimate the future tax burden associated with a deficit-financed spending programme and at the same time overestimate the benefits that they derive from the programme. Even without such an illusion, an uneven distribution of costs and benefits may explain the extra-spending bias. Some groups may enjoy special benefits, such as spendthrift general government units or groups that will play a key role in securing an election victory.

Meeting the main criteria for an effective fiscal rule

The economic literature has highlighted the usefulness of formal rules backed up by a credible institutional framework to manage fiscal-policy adjustments and prevent structural imbalances from emerging. To play its role, a fiscal rule must be clearly defined, transparent, straightforward, flexible, suited to its ultimate objective and consistent (Buti *et al.*, 2003).

A spending cap rule scores favourably according to these criteria. It is based on an aggregate that is easy to measure and it is relatively simple to operate, which simplifies the task of verifying enforcement. Furthermore, to the extent that rising spending is the main reason for persistent budget deficits, a cap is suited to its end objective. Satisfying these criteria lends added credibility to the government's commitment to comply with a fiscal rule. However, as with any fiscal rule, the effectiveness of a spending cap will depend to a large extent on building a political consensus around the new constraint on fiscal policy and on having the institutional mechanisms in place to make sure the rule is enforced.

2.2.2 *Defining the rule*

It must be borne in mind that a spending rule is merely a tool to make fiscal policy more credible. The measures actually deployed to control spending growth in the long run will play a crucial role in determining whether the rule's targets are met. Subject to this requirement, a number of points must be clarified if a fiscal rule to cap spending is to be properly effective.

Coverage must extend across the whole of general government

Partial coverage not only limits the effects of the rule but also creates the risk that some expenditures will be transferred to government units outside the scope of application. Central government budget spending in France has complied with a zero real growth rule since 2003, but expenditures by other general government units are not subject to a cap, so they have tended to increase fastest.

Which spending items should be covered?

While the cap should apply to the whole of general government, some types of spending may be excluded without making the rule less effective.

- In the short term, changes in the debt burden depend mainly on interest rates, which are outside government control. Including this category in the cap could create windfalls (other spending may potentially be raised if rates go down) or unnecessarily restrictive effects (other spending may have to be cut to offset the impact of higher rates).
- Public investment expenditures may also qualify for special treatment, because they are ultimately self-financing owing to the increase in potential output. If these expenditures were included within the cap, governments might be tempted to reduce them excessively, because lowering this type of spending often carries a lower political price tag than cutting current expenditures. At the same time, saying which spending is productive may be tricky, because this category extends beyond government investment expenditures to include items like higher

education spending, for example, which is a prominent component of government consumption.

- Cyclical spending (unemployment insurance benefits and other transfers that vary according to economic conditions) should also be excluded because these expenditures acts like automatic stabilisers. Setting an arbitrary cap that applied regardless of economic conditions would force governments to make up for the increase in benefits at the bottom of the cycle by squeezing other spending, while conversely leaving room to raise other spending at the top of the cycle.

However, the government must be prevented from circumventing the spending cap via tax expenditures, which amount to a discretionary reduction in revenues from an accounting perspective, but produce the same economic effects as spending.

Nominal or real spending?

A nominal target is easier to track, but makes it impossible to react if prices move in an unforeseen direction.

The most common approach is to adopt a real target, which neutralises inflation-forecasting errors and setting spending objectives that are based on real growth. France opted for this solution when it adopted a growth rule for central government budget spending.

What is the appropriate horizon?

A cap may be set each year, which would have the advantage of coinciding with the annual Budget Act. However, a horizon this short offers little visibility to economic agents, making the government's long-term commitment to control spending seem less credible. By contrast, a multi-year cap, say over a parliamentary term, would alleviate some uncertainty among economic agents over the direction of fiscal policy. There is also the question of whether the cap should be adjusted to reflect outcomes following its introduction. A pre-set rate at the beginning of the period may strengthen the faith of economic agents in the long-term nature of the commitment to rein in the deficit. Such an approach may be advantageous if the outstanding imbalances are particularly large. If they are not, it is better to retain some flexibility to respond to cyclical fluctuations.

What level should the cap be set at?

The spending growth target depends on two factors: expected revenues over the period, which, excluding discretionary measures, are linked to nominal GDP growth; and the need to reduce the actual ex ante government deficit and/or government debt.

The future path of revenues must take in account both the economy's potential growth and also its position in the cycle at the beginning of the period. Factoring in a growth lag or surplus, as measured by the output gap,¹ avoids setting overly generous spending caps at the peak of the cycle and overly strict caps when times are harder. However, the concept of the output gap is itself based on the notion of potential output, which is tricky to measure.

A rule backed up by credible institutional mechanisms

As with any fiscal rule, the effectiveness of a spending cap depends to a large extent on the mechanisms that are introduced to ensure compliance. If the cap is adopted at a senior institutional level (e.g. by parliamentary vote rather than a mere commitment by the government), then breaking the rule will be more costly in political terms. Furthermore, the rule should provide for swift correction of breaches that are discovered after the fact, which requires timely management of changes in public spending by the competent authorities.

2.2.3 Introducing spending caps within the European fiscal surveillance framework

The institutional framework introduced at the EU level to supervise national fiscal policies is centred on compliance with the two reference values established in Article 104 of the Treaty for the general government deficit (3 per cent of GDP) and general government debt (60 per cent of GDP). There is no single standard for the growth rate of public spending or revenues, or their level relative to GDP.

This situation primarily reflects the continued existence of national fiscal sovereignty. Subject to the deficit and debt limits set down in the Treaty, Member States remain free to determine which fiscal measures they should take to ensure sound public finances.

A second reason is that there is considerably diversity in the budgetary positions of EU countries. Public spending ratios are still relatively varied and there are some considerable differences in average growth rates for public spending. This non-uniformity increased when the EU welcomed its new members on 1 May 2004. Table 4 shows that while broadening did not lead to an increase in the dispersion of public spending ratios or general government balances, the same was not true for spending growth.

The Stability and Growth Pact (SGP) places added focus on public spending

The reform of the SGP, adopted by the European Council on 22 and 23 March 2005, deals with several aspects of controlling public spending:

¹ The output gap is the difference between potential and actual output.

Table 4

Standard Deviation in the Euro Area, EU-15 and EU-25
(ratio and balance as a percent of GDP, growth rate as a percent)

	Euro Area	EU-15	EU-25
Government spending ratio	5.4	5.9	6.2
General government balance	2.4	2.4	2.3
Real growth rate of public spending	2.2	2.2	4.9

- the target of cutting 0.5 point of GDP a year from the cyclically-adjusted budget balance may be adjusted depending on economic conditions (greater consolidation during good times, less during hard times). This adjustment supports the adoption of a flexible spending cap that can be adjusted based on economic conditions;
- a distinction is drawn between different spending categories. Some of these (public investment, research and development, expenditures related to structural reforms, financial contributions aimed at supporting European unification or fostering international solidarity) may be used to justify a temporary overshoot of the reference value of 3 per cent of GDP or a temporary deviation from the target of reducing the cyclically-adjusted budget balance by 0.5 point of GDP;
- as part of measures to enhance governance, Member States are encouraged to introduce fiscal rules (spending caps being cited as one of the possible rules) as an additional instrument to help ensure compliance with SGP targets. Implementation of these national rules may be discussed during the examination of stability and convergence programmes.

Public spending controls in the EU: enforcement varies to a relatively large extent

All EU-15 countries have gradually introduced mechanisms to cap public spending. However, some arrangements are stricter than others (European Commission, 2003). The Netherlands and Scandinavian countries have been most successful.

- In 1994, the Netherlands adopted a cap that applies for an entire parliamentary term (four years in theory). At the beginning of its term, the Dutch Parliament votes on limits for spending growth, which are set for each year in real terms for each of the general government sub-sectors. The caps are set in such a way that the automatic stabilisers can function on the revenues side without creating the risk that the deficit might breach the 3 per cent of GDP threshold. Enforcing this rule led to a marked slowdown in the growth of current primary spending until

2000. Although help may have come from the reduction in the twin burdens of debt and unemployment benefits as a result of robust economic growth, the European Commission noted in its 2003 annual report on public finances that the cap made it possible to scale back discretionary use of public spending to cope with unforeseen shocks. Some slippage was noted starting in 2001, owing to a greater-than-expected spontaneous increase in healthcare and unemployment spending. However, structural reforms were implemented that quickly corrected the overshoot from 2004 onwards (see Figure 9).

- Sweden adopted a slightly different mechanism in 1997. Each year, Parliament votes on a three-year cap on public spending growth. The cap excludes the debt burden and is broken down for each government unit. The public spending growth rate is determined such that the ratio of public spending to potential output remains stable. As in the Netherlands, the mechanism worked perfectly in the initial years before giving way to some drift in 2002 and 2003 as healthcare and unemployment insurance spending grew too swiftly. However, the Swedish government introduced measures that corrected the slippage from 2004. In all, Sweden has met its target of keeping a stable primary spending/GDP ratio since the mechanism was introduced. The ratio stood at 54.5 per cent of GDP in 2005, compared with 55.2 per cent in 1998 (see Figure 9). In both countries, the main reasons for success seem to be the political consensus surrounding implementation of the cap and the rapid correction of slippage that was observed ex post. However, the spending category that is apparently hardest to control is social benefits in cash and in kind. These benefits are highly sensitive to changes in economic conditions.

There is now a broad-based consensus in Europe that growth in public spending must be controlled before sustainable public finances can be achieved. The need for consolidation is especially pressing because population ageing is going to put added strain on the public finances in the years ahead. The European Commission (2006) believes that spending on pensions, healthcare and long-term care could increase by an average of 3 per cent of GDP in the euro area by 2030.

Efforts to control the quantity of spending must be accompanied by a strategy to improve the quality of public spending so as to maximise its impact on growth.

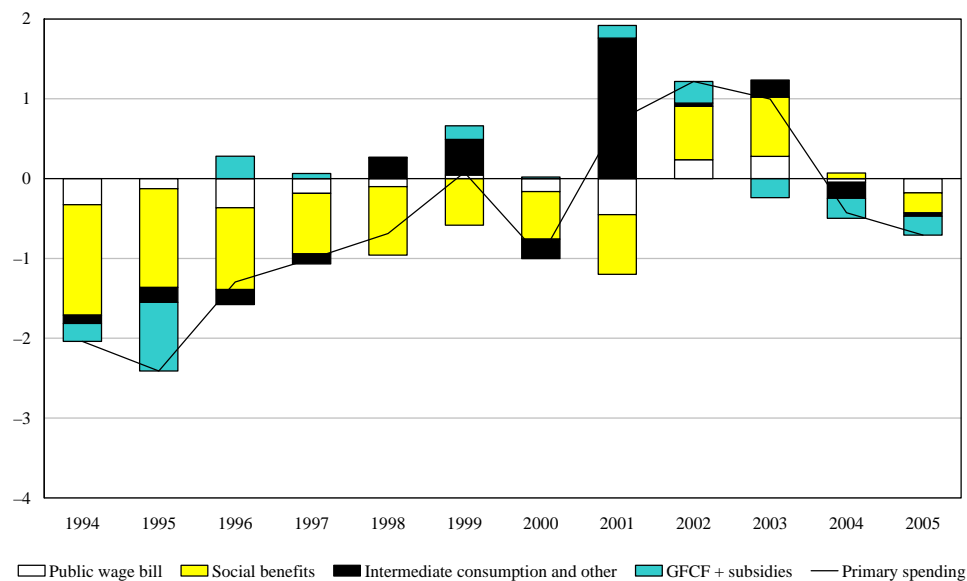
Caps on the growth of public spending have proven themselves to be effective at achieving these goals. The European institutions recommend implementing these mechanisms at the national level and many countries have done so with success.

Finally, a policy to achieve long-term control over growth in public spending should form part of an overall strategy aimed at increasing potential output and employment.

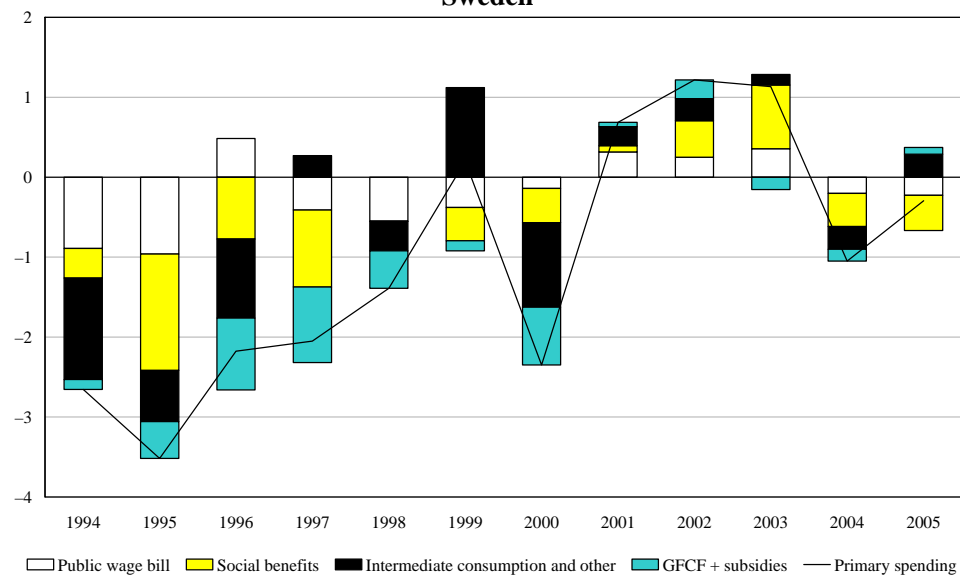
Figure 9

Decomposition of the Change in the Primary Spending Ratio (percent of GDP)

Netherlands



Sweden



Source: European Commission Calculations: Banque de France.

3 Conclusions

Excessive and growing government debt has negative longer-term consequences for economic fundamentals. For this reason, every country must consider whether its government debt is on a sustainable trajectory path and introduce a debt-retrenchment strategy if necessary. In this respect, the revised SGP assigns added importance to the sustainability of fiscal policy, but stops short of giving the debt criterion a more operational role. Within the framework of a debt retrenchment strategy, an increase in potential growth, which has a beneficial effect on public finances and macroeconomic conditions alike, is always desirable. However, the reforms required to achieve this outcome are complex and their impact is not only uncertain but also unclear in the short term. Accordingly, the best debt retrenchment strategy appears to be to build up sustainable primary budget surpluses. While previous slippage in public spending caused the excess deficits, getting spending under control is, judging by the experiences of a range of countries, a reliable way to consolidate the public finances and reduce debt. An effective way for governments to achieve this is by implementing fiscal rules to control spending growth. However, broad-based public support is vital if these objectives are to be attained.

APPENDIX

The Hair-raising State of France's Public Finances

All the indicators and studies show that France's public finances are in a worrying state, even though the wider population is not yet fully aware of this. Over the last three decades, successive governments have failed to make balancing the public books a central economic policy priority. Given the risk that the increase in debt could become self-sustaining and in view of the considerable inertia of public spending, a long-term consolidation strategy must be deployed now, since any deferment will result in extra costs.

In 2005, the level of debt in France was not yet at a critical point, but the growth rate was already a source of concern. The debt/GDP ratio has tripled since 1980 (Figure 10) and all the projections indicate that if reforms are not undertaken, the ratio will reach unsustainable levels within a few years. Under reasonable macroeconomic assumptions, the debt ratio would on its current path reach around 100 per cent of GDP by 2015.

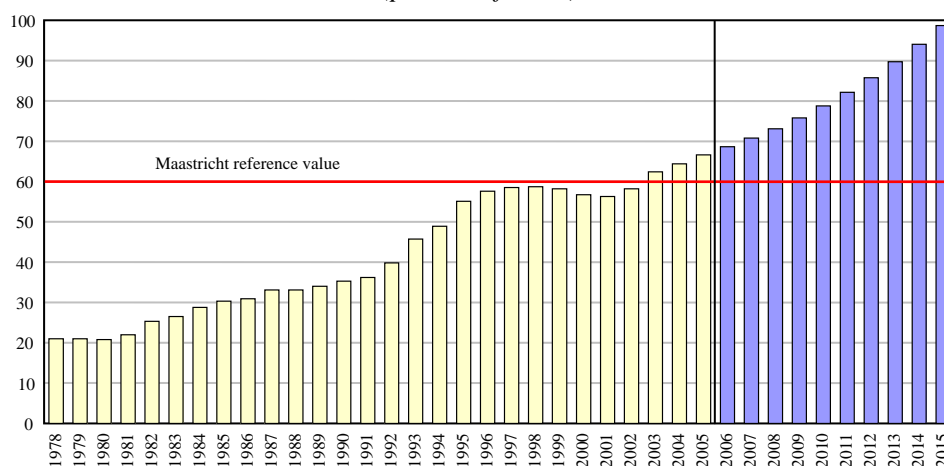
France cannot blame these developments on a war or a major economic shock. Initially, the increase was painless from a fiscal perspective as long as the structural imbalances were financed by spells of unexpected high inflation. Low or even negative real interest rates helped to contain the increase in debt. But from the early 1980s onwards, the latent imbalances were revealed as inflation was brought under control (leading to more accurate expectations) and reduced and as growth slowed markedly. The increase in the debt ratio is the result of structural and unsustainable slippage in public spending. Corrective action must be taken as soon as possible, bearing in mind that it is harder to make adjustments when big changes are needed.

If the GDP share of primary spending had been kept at its 1991 level, the debt ratio would now be stable at around 50 per cent of GDP. If the same adjustment had been implemented in 2000, when the public finances were benefiting from a cyclical upswing, the debt ratio would again be in the region of 50 per cent (see Figure 11). Today, however, a much bigger adjustment is needed because the level of public spending is higher and is under strong upward pressure from population ageing. Further, in France today, monetary policy is centralised at the European level, interest rates are historically low, the economy is growing at a moderate pace and tax and social security contributions are high. The public finances need to be consolidated by reforming transfers to private agents and/or by conducting an overall analysis of the choices, effectiveness and oversight of public spending as a whole.

Like most of the EU-15 countries, France saw the GDP share of its public spending grow sharply after the second world war, from around 35 per cent of GDP in 1960 to 54.4 in 1993. Since then, and in contrast with most EU countries, the spending ratio has not fallen but has stabilised at a high level. The sustained growth in French public spending since the early 1970s is the result of a combination of factors.

Figure 10

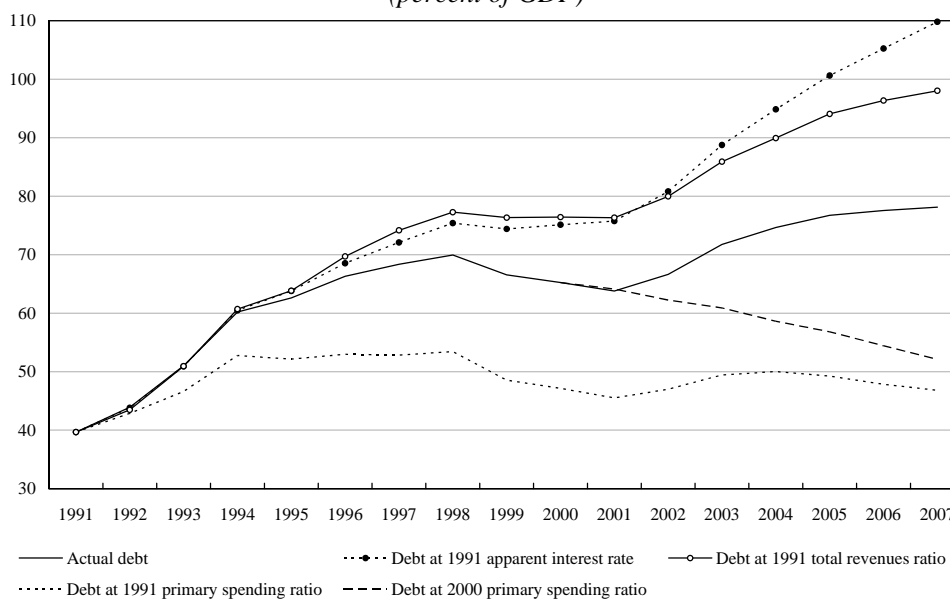
France: Public Debt Ratio
(percent of GDP)



The base year for the period 1978-94 is 1995; in the future it could be revised.
Source: National Accounts. Since 1995, base 2000, INSEE.

Figure 11

Future Path of Debt under Several Assumptions
(percent of GDP)



In the first place, the uptrend in public spending can be attributed to the increased scope of the public sector. The share of public sector employment in total employment increased by 8 percentage points between 1970 and 1994, before dipping slightly (Figure 12). Collective preferences partly explain France's bias towards public provision. In particular, French public authorities responded to the need among the general population for more insurance provision with measures that helped to extend the welfare system. For example, a new “dependency” risk appeared in 2002 with the creation of special benefits for the elderly (Allocation personnalisée d'autonomie – APA). Also, a universal health coverage system was set up in 1998. Figure 13 illustrates the way that public spending by social security agencies has risen in the last 30 years. However, aside from responding to the needs of the population (education, healthcare, etc.), recruitment in the general government sector was also aimed at sustaining employment. Yet growth in the public wage bill is inherently difficult to reverse, especially when it comes to the recruitment of civil servants.

The trend increase in public spending is also the result of asymmetric management of spending over the economic cycle. Thus, between 1979 and 2005, if we add the years of increased spending, we find that the spending ratio increased by 14 percentage points. Only about one-third of this was offset by reduced spending in other years (–5.7 percentage points). Overall, the French public spending ratio rose by 8.3 pp. The following table breaks down the increases and decreases in primary spending items. Aside from the wage bill and public investment, the other main items have increased far more than they have decreased. The uptrend in benefits, in particular, reflects two factors: not only have these expenditures risen more often than they have declined, they have also increased by more (on an annual average) than they have declined. The spending dynamic is therefore doubly asymmetric, both over time and in quantitative terms.

The excess spending during cyclical dips, which sometimes went beyond the free operation of the automatic stabilisers, continued when economic conditions brightened and were not always fully financed by equivalent revenue increases, thus leading to high, persistent deficits. In the institutional context of the 1990s, during preparations for membership of monetary union, a series of French governments worked to halt the increase in spending in order to comply with the Maastricht criteria. However, the primary public spending ratio merely stabilised on average at a high level, while many other EU-15 countries reduced their ratios significantly and sustainably. It seems in other words that the French spending control strategy was not sufficiently effective. Yet consolidation efforts have been backed up by rules. Since 1997, for example, Parliament has voted each year on a national target for health insurance spending. And since 2003, the annual budget has assigned a spending growth target for central government.²

² Until 2006, the aim was to hold central government spending growth to 0 per cent in real terms. The growth target from 2007 onwards is –1 per cent in real terms.

Figure 12

Public Sector Employment in Relation to the Private Sector and Public Sector Wage Bill, 1970-2005

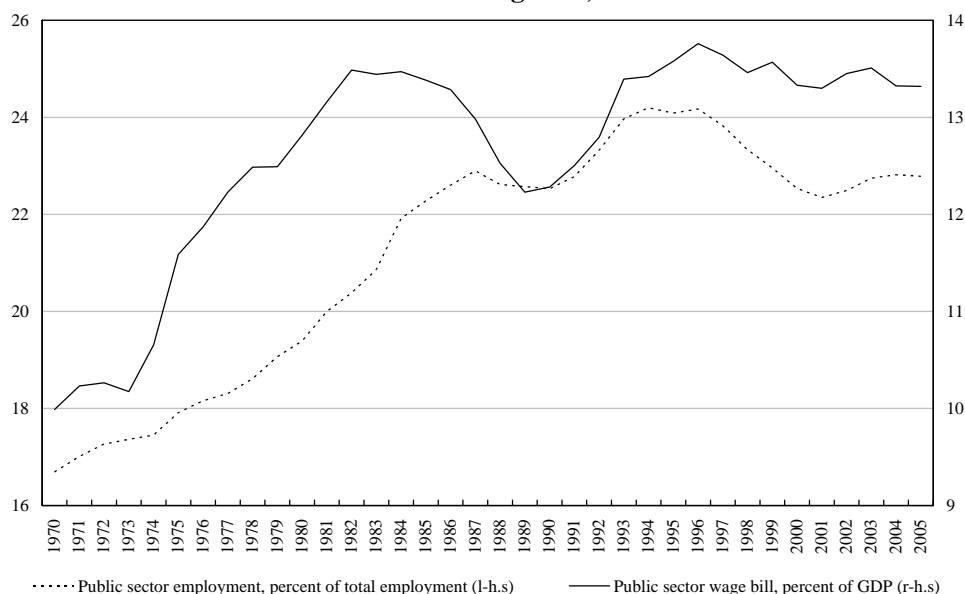


Figure 13

Increase in Welfare Spending, 1978-2005

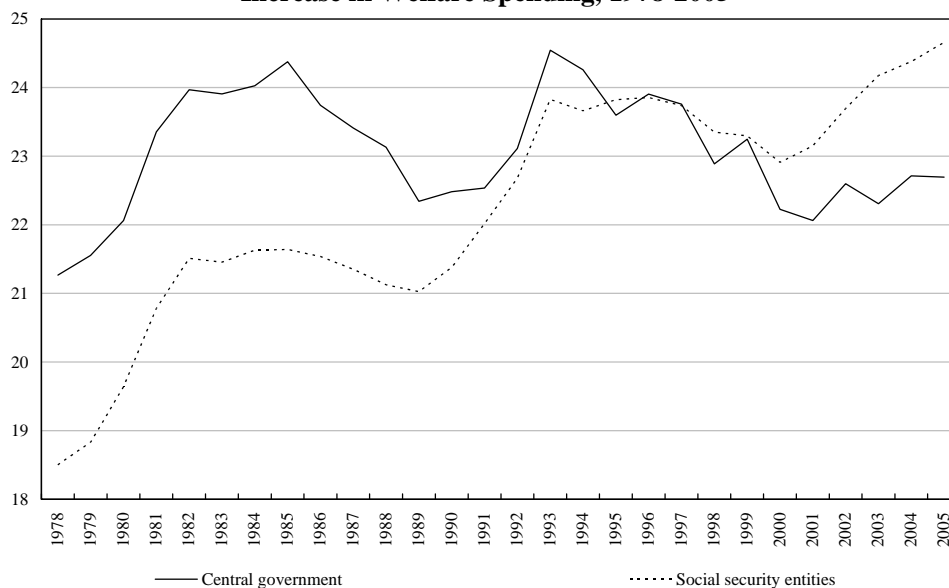


Table 5

**Decomposition of the Increase/Decrease in Primary Public Spending
(1979 and 2005)**

	GDP share			Increase		Decrease	
	1978	2005	Difference 1978-2005	Total	Number of Years	Total	Number of Years
Social benefits (in cash and in kind)	18.5	23.6	+5.1	+7.2	20	-2.1	7
<i>Social benefits in cash</i>	14.8	17.9	+3.1	+5.2	17	-2.1	10
<i>Social benefits in kind</i>	3.7	5.7	+2.0	+2.6	20	-0.6	7
Public sector wage bill	12.5	13.3	+0.8	+2.8	15	-2.0	12
Public investment	3.0	3.2	+0.2	+1.5	15	-1.3	12
Other spending (intermediate consumption and subsidies, etc.)	8.8	11.0	+2.2	+4.7	18	-2.5	9
Total primary spending	42.9	51.2	+8.3	+14.0	16	-5.7	11

However, both these rules suffer from gaps: there is no penalty mechanism. For example, since it was first set and through to 2005, the target for health insurance spending was systematically exceeded without any real consequences; the scope of application is not sufficiently exhaustive. As a result, while the increase in central government spending has been curbed in recent years, the same cannot be said for other government sub-sectors, which are not subject to any rules. Spending that was initially within the purview of central government has actually been devolved to local government in part of decentralisation measures. Transfers to the regions of fast-growth spending items like the APA or income support (Revenu minimum d'insertion – RMI) certainly helped central government to meet spending targets, but led to an increase at the local government level.

The French spending control mechanism has not helped to consolidate the public finances or control the debt ratio. Yet the demographic changes that are foreseeable in the short and medium term will exacerbate these problems. The European Commission is forecasting public spending linked to population ageing to increase by 3.2 pp by 2050. At that time, the government debt ratio could reach 240 per cent of GDP according to Commission, and up to 400 per cent according to the Pébureau Report. Faced with these additional requirements, the government will definitely not be able to respond solely by increasing statutory charges, which are already among the highest in Europe. But long-term control of spending growth, coupled with more efficient, better-quality public spending, looks like a winning strategy from a fiscal and macroeconomic standpoint. This, at least, is the lesson learned from successful experiences by other countries.

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