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French Public Finances at Risk?

Summary: Using descriptive evidence, this paper contributes to the debate on French public finances' consolidation by examining the long-term sustainability of France's fiscal position. We trace the historical trends of government's tax receipts and expenditures. We illustrate that while the level of public expenditure in France is larger than in the Euro Area, its trend is comparable to its neighbours. French net debt is comparable to Eurozone's while French net wealth remains positive. However, the French tax system is not progressive with only 6% of compulsory levies raised that way, and too complex. The paper then acknowledges the efficient debt management of French authorities. As a conclusion, we see no risk of future unsustainability linked to the nature or the level of current French public finances.

Key words: Deficits, Debts, Debt management, Taxation.

JEL: E62, E63, H61, H68.

In the fall of 2009, while the rest of the world embarked on a fragile recovery, the emergence of public finances' problems in Greece (the revelation of wrongdoings in debt management) plunged the Euro Area in a new period of turmoil. The EMU peripheral countries were forced (by markets or by fellow European governments) to pursue repeated consolidation plans. A growing bifurcation happened between a more or less healthy core (Germany, Finland and Austria), and a periphery that is entangled in a recessionary vicious circle.

Within this picture France's situation is interesting for a number of reasons. First, it is very hard to classify it in terms of the dichotomy between core and periphery. Indeed, its economy is struggling in terms of (price and non-price) competitiveness and public finances, yet it remains strong and resilient thanks to a high labour productivity per hour worked, good infrastructures, large multinational firms in the corporate (most notably, in energy) and financial sectors, and relatively high R&D expenditures in the public sector[1]. France has chronic public deficit problems, and yet its debt level remains manageable (sovereign interest rates have been historically low in recent years).

[1] See Louis Gallois (2012) for a view of the weaknesses and strengths of the French economy.

The second reason of interest relates to the debate on the Euro Area. The prevailing narrative blames the crisis on the fiscal profligacy of peripheral countries (a critical view of this conventional narrative can be found in Angelos A. Antzoulatos 2012). Consequently, the EMU embarked on reforms of its governance that strengthen the limits to government action in particular concerning macroeconomic management. These reforms took for granted two assertions: first, more stringent fiscal rules would benefit the Euro Area as a whole and, second, limiting deficits and debts has become an objective of economic policies, thus changing the status of public finances from instruments to policy objectives. These two assertions have not been discussed, and are empirically weak: fiscal rules in the Euro Area have prevented neither macroeconomic instability nor the sovereign-debt crisis. On the other hand, the wave of fiscal consolidation in the EU has paved the way for recession and higher unemployment. In May 2012 François Hollande was elected president of France during the ratification process of the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* (Fiscal Compact) signed by his predecessor Nicolas Sarkozy. While rejection of the Fiscal Compact, a tightened version of the Stability and Growth Pact (SGP), was pivotal in Hollande's campaign, the ratification process continued. Moreover, France gave up its ambition to form a coalition opposing European austerity policies: in September 2012 it even passed a budget law for 2013 imposing a consolidation effort of 34 billion €, 1.5% of French GDP and beyond what is required by the *Fiscal Compact*.

Why did not President Hollande follow the promises of the candidate Hollande? An interpretation is that between election and the budget law of September 2012, European financial markets had a summer of turmoil, with speculative attacks against Spanish and Italian sovereign bonds that only stopped when the ECB announced the Outright Monetary Transactions (OMT) program. The French government could have feared to be the next in line, and to avoid being targeted by speculation, it decided to take action and bring the deficit within the 3% limit. The argument would go that French public finances being in a dire state, the current very low yields on French treasuries were the effect of wrong market perceptions, and that when the attention turned to France it better be able to prove that it was a good pupil.

We consider the premise of that argument, which is that France has a problem of public finances sustainability. The definition of public finances' sustainability is a tricky one. In today's economy, and in particular in a monetary union without a federal government and centralized fiscal policy, a number of factors affect the future path of debt and deficit, not all of them under the direct control of national governments. The Greek consolidation experience which started in 2010 shows that deficit reduction efforts led to no appreciable improvement of long term sustainability, as they were undermined by a general lack of confidence not so much on Greece's efforts, but more generally on EMU governance and on the capacity of European countries to properly manage the crisis[2]. In the present context, in particular, it is worth mentioning two elements: The first is the capacity of the EMU to rely on a proper lender/buyer of last resort. The ECB as of now has no such power, and the OMT

[2] Due to positive fiscal multiplier effects, Greek fiscal efforts to achieve fiscal sustainability were also undermined by the deep recession.

program is only a pale surrogate. The second is the already mentioned capacity of EMU leaders to overcome the construction flaws of the single currency, in particular endowing the Eurozone of some sort of mutual insurance. On both counts while the French political impulse may prove in the future crucial, its impact through public finances management is virtually non-existent. A last element that can play a role in public finances' sustainability is the percentage of debt held by non residents, that for France is around 55 per cent of the total, only slightly above Germany at 52 per cent (data, for 2012, are from Eurostat). We therefore decided to adopt a narrow definition of sustainability, that focuses on past and current trends of public finances' variables (expenditure, revenues, debt), that are more easily under the control of the French government.

After giving some context in terms of international comparison of public finances' aggregates, we trace the evolution and the composition of government revenues and spending. We then look at the structure of the French public debt (average maturity, interest rates, and so on). The conclusion is that there is no serious reason to worry about sustainability, even if French public finances can certainly be improved in terms of fairness and efficiency.

1. French Public Finances: An Overview

1.1 The Long Term Trend in Public Finances: An International Comparison

If we take a long view, as in Table 1, we can observe that France on average since the 1980s has never run deficits substantially larger than the average of other OECD countries. Quite naturally, this translates into an accumulated stock of debt that is also not significantly different from other countries. French gross debt remained slightly below the Euro Area average during the crisis, and is forecast by the IMF to remain so in the foreseeable future.

While France's public finances' balances do not stand out as special, its share of government expenditure is indeed larger than in other large economies. Government expenditure in France is over 12 percentage points higher than the average of OECD countries, and 5 points larger than the second largest spender, Italy. Also for the ratio of government consumption spending to GDP, France stands well above the OECD average, even if the difference is not as large as for total expenditure.

1.2 Trends in Expenditure

The ratio of total government expenditure over GDP has been almost constantly increasing since the late 1950s. In 2011 it amounted to 56% of GDP. This ratio is almost 7 percentage points larger than the Euro Area average. To a certain extent this comparison is influenced by the fact that in some countries, health, education and pension services are provided by the private sector[3].

[3] In France, the health system operates mostly as a public insurance system even though a large part of health care supply is provided by private doctors (*médecine libérale*).

Table 1 Public Finance Indicators

	1980-1989	1990-1999	2000-2007	2008-2012	
Government net lending (% GDP)*					
France	-2.4	-3.9	-2.8	-5.5	
Germany		-3.4	-2.3	-1.7	
Italy	-10.7	-7.4	-3.0	-3.8	
Japan	-1.7	-3.3	-5.4	-7.7	
UK	-2.8	-3.8	-1.7	-8.2	
USA	-4.2	-3.0	-2.6	-9.7	
OECD	-3.9	-3.4	-2.1	-6.3	
Government disbursements (% GDP)*					
France	49.9	53.0	52.8	55.8	
Germany		48.7	46.5	46.1	
Italy	47.9	52.2	47.5	50.4	
Japan	32.8	35.0	37.2	41.2	
UK	45.4	42.2	41.8	49.3	
USA	36.3	36.7	35.8	41.3	
OECD	40.6	41.3	39.4	43.0	
			2007	**2012**	**2017**
General government gross debt (% GDP)**					
France			64.2	90.0	86.5
Germany			65.4	83.0	73.7
Italy			103.1	126.3	120.6
Japan			183.0	236.6	250.3
UK			43.7	88.7	93.7
USA			67.2	107.2	114.0
G7			83.5	125.1	127.6
Euro area			66.4	93.6	89.5

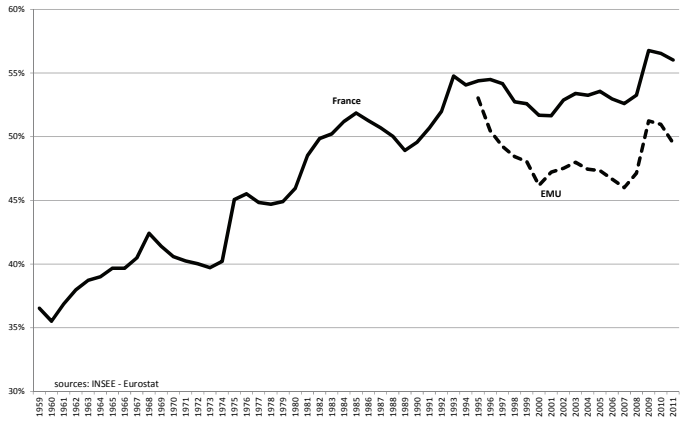
Note: Unless otherwise specified, in this and in the following tables and figures, we report data downloaded from Thomson's Datastream or from the sources' websites, on which we performed our own calculations.

Source: * Organization for Economic Co-operation and Development (OECD), ** International Monetary Fund (IMF) World Economic Outlook.

A large part of the increase in public spending over GDP happened between 1959 and the early 1990s (see Figure 1). The average growth rate between 1959 and 1993 was of 1.2%, while since then it has increased by 0.1% per year (it actually decreased before the crisis started in 2007). Contrary to conventional wisdom, the ratio of public expenditure to GDP had stabilized before the crisis; most likely, this happened thanks to the external constraint represented by the Maastricht treaty and the European fiscal norms.

Looking at the composition of public spending (Table 2) with respect to the Euro Area average most of the extra spending of France comes from public wages and social benefits (in both cases about 2.5 percentage points more than Euro Area average). Spending for public investment is also larger in France, but in both cases the amount seems rather modest especially if we consider that it is gross investment, including capital depreciation.

The largest part of spending in 2011 goes to social benefits (46%), and to public wages (23%). Interest charges only account for 5% of overall spending. This is, of course, due to the exceptionally low level of interest rates - a consequence of the storm that has hit Euro Area peripheral countries -, but also to a skilful management of the debt stock.



Source: National Institute for Statistics and Economic Studies (INSEE).

Figure 1 Total Expenditure as % of GDP

The most substantial source of spending cuts in France since the 1980s has been wage restraint. Governments implemented a strict management of public-sector wages, especially between 1984 and 1987 and between 1992 and 1993. The persistent high unemployment rate in France certainly helped curbing wages both in the public and in the private sector. Moreover, since 2004, public-sector employment started decreasing because retirees from the public sector have no longer been fully replaced.

Conversely, social expenditures and transfers rose sharply (old-age and health expenditures). This occurred in spite of a series of measures designed to restrict eligibility and generosity of the various allowances, most notably old-age pensions, unemployment benefits, active labour-market policies (like programs of subsidized employment contracts for low-skilled workers) and health care reimbursement. Nevertheless, the government has recently enacted subsidised full-time jobs*, emplois d'avenir*, which are planned to last a maximum of 5 years and are paid at least the minimum wage, with 75% of funding by the State, and the rest of the cost borne by local authorities, associations, foundations and business. According to Eric Heyer and Mathieu Plane (2012), the creation of 150,000 of these jobs will increase the *ex post* budget deficit by a mere 0.1% of GDP after 5 years, with an *ex ante* cost of 0.2% of GDP.

Table 2 Composition of Government Expenditure in 2011, in % of GDP

	Eurozone	France
Intermediate consumption	5.5	5.5
Compensation of employees	10.6	13.2
Interest	3.0	2.6
Social benefits	23.1	25.6
Capital investment	2.3	3.2
Other	4.9	5.9

Source: Calculated from INSEE and Eurostat.

1.3 The French Tax System

Four important features are generally associated with the French tax system: tax levies are high, the progressive part of the French tax system rests on a narrow basis, the French tax system lacks fairness and is very complex.

1.3.1 Tax Levies Are High

The rise in compulsory levies (in proportion to GDP) has been very strong between the early 1960s and the late 1990s (Figure 2). The longest and steepest increase occurred after the first oil shock and up to the mid-1980s, hence after the so-called "Trente Glorieuses", the almost uninterrupted 30 years of strong economic growth after WWII. The rise in taxes in France has coincided with new social spending, higher public debt and subsequent net interests.

In 2011 the global average tax rate in France was 45%, to be compared with an average EU tax rate of 40%. The level of compulsory levies in France is certainly high. It has been relatively constant since the late 1990s, despite several attempts to reduce tax rates under the mandates of Presidents J. Chirac and N. Sarkozy. The most noticeable tax modification has certainly been the 50%-cap according to which the total amount of direct taxes paid by a household could not exceed 50% of its annual (capital and labour) revenues. Introduced in 2007, this measure was later abolished when the size of consolidation required sharing the burden between higher taxes and lower spending. The motivation of the 50%-cap (known as the tax shield) to foster private entrepreneurship was finally in contradiction with the necessity of funding fiscal packages for private firms (like the car industry and banks) and social spending to dampen income losses during the financial crisis.

1.3.2 A Progressive Tax System with a Narrow Basis

Tax revenues in France can be split into four main categories: income taxes, capital taxes, consumption taxes and social contributions. Their different shares are uneven. In 2011, the personal income tax represented 21% of overall taxes in France, taxes on capital 14%, consumption taxes 23% and social contributions 42%. Since only the personal income tax retain some progressivity, it is clear that the French tax system is not progressive. This is not new: the progressive part of the tax system has long rested on a narrow basis.

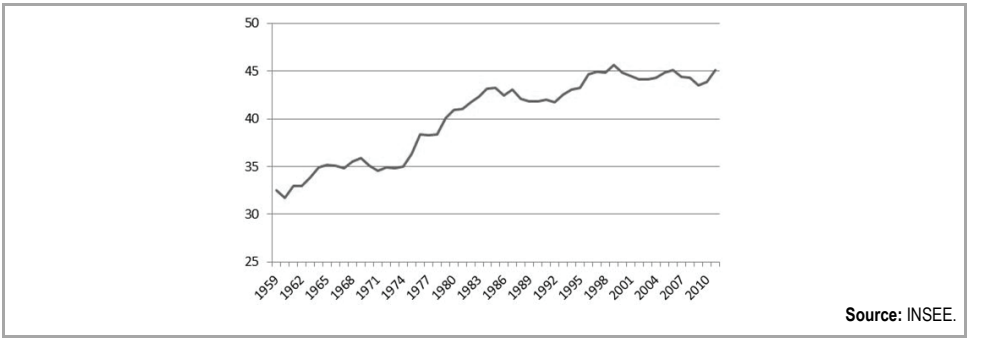


Figure 2 Compulsory Levies, in % of GDP

Income taxes are split into two categories: the first one (IR) is a progressive tax with tax rates going from 5.5% to 45% of household income; and the second one (CSG+CRDS)[4] is a flat tax at 8% of household income. Both taxes are levied on labour and capital incomes, but the yield of CSG+CRDS is almost twice that of IR, almost 100 vs. 50 billion € per year in 2010. IR revenues make 6% of the total amount of compulsory levies in France.

Capital taxes are levied on corporate profits according to a flat rate of 20%, which yields 35 billion € of revenues per year; a wealth tax is levied according to a progressive system that yields 3 billion € of tax revenues per year. A property tax complements capital taxes and yields 15 billion € per year.

Consumption taxes yield more than 200 billion € per year. By their nature, these taxes are regressive: low income households pay a higher share of their income in consumption taxes than high income households.

The main remaining part of compulsory levies is social contributions. French households pay far more than in other European countries for social contributions (17% of GDP in 2011 against 13% according to Eurostat). Moreover, taxes on labour amount to 23% of GDP against 20% for the EU-27 weighted average). It is important to remember nevertheless that French social contributions not only finance replacement incomes (pensions under a PAYG system, and unemployment allowances, 13% of national income) but also health insurance, family allowances and vocational training.

1.3.3 The French Tax System Lacks Fairness and Is Complex

Camille Landais, Thomas Piketty, and Emmanuel Saez (2011) show that the French tax system is regressive: although from the 1st to 50th percentile, effective tax rates are smoothly growing, they remain constant between the 50th and the 95th before declining rather substantially for the top-5% of the income distribution. Hence, while households from the middle-class pay almost 50% of their income in taxes, those in the top 0.1% pay only 35%.

This happens for two reasons. First, most of tax revenues come from regressive levies like consumption taxes or social contributions. The latter are used to finance allowances that benefit more pensioners with high life expectancy, usually the wealthier ones: between 2000 and 2008, the ratio of life expectancy at 60 between senior executives and workers (resp. employees) was 1.22 (resp. 1.14) according to INSEE. Second, the narrow basis for progressive taxation makes it impossible for the income and capital taxes to dampen the regressive feature of other taxes.

The large incidence of social contribution to tax revenues makes it difficult to draw comparisons with other countries; besides, the French tax system includes approximately 400 tax exemptions which limit the yield of these taxes. They can be divided in five categories. First, a few taxpayers receive large tax exemptions for their investments in the film industry or in the overseas' departments. Some firms also receive research tax credits, proportional to their spending in R&D. In 2010, this

[4] CSG: generalised social contribution; CRDS: contribution to repay social debt, initially a temporary tax which has seemingly turned into a permanent one.

latter measure produced 5 billion € worth of tax reduction for firms. Second, donations up to a threshold give right to an exemption. Third, the use of the denomination "taxable income" reveals that a certain part of income is *automatically* exempted from the income tax: 10% of wages and pensions (up to a threshold) and up to 40% of dividends (without limit) are exempted. Fourth, up to 10,000 €, half of the gross nominal wage, including employer social contributions, paid for home employments (maids, baby sitters), also gives rise to a tax reduction. Fifth, the consumption tax system includes lower VAT for some foods, for restaurants and for craftsman work.

1.3.4 The French Tax System under Reform

The intensity of fiscal reforms has been very substantial since 2012 when fiscal consolidation has strengthened. In 2012, the government undertook 45 tax and social measures that raised additional 20 billion € of tax revenues, 1% of GDP. Among these 45 measures, only 6 of them, amounting to 6.4 billion €, were tax *reductions*.

Different fiscal reforms have been undertaken since the 1990s in France. First, the value-added tax (VAT) has witnessed many changes since the late 1980s. The VAT rate decreased in 1988 to comply with EC harmonization but then in 1995 the highest rate rose from 18.6% to 20.6%. On 1 April, 2000, the VAT slightly declined to 19.6%, with a reduced rate at 5.5% in agreement with Appendix H of European VAT Directive of 1977. In late 2011, VAT on a large number of goods formerly falling in the 5.5% category was increased to a newly introduced rate of 7%. In January 2014, the French government will implement a VAT reform, meant to yield 6 billion € of extra revenues per year: the 7% and 19.6% rates will be increased to 10% and 20% respectively, while the 5.5% rate will be reduced to 5%.

Second, the tax on corporate profits has been declining during the 1980s to harmonize with other EU member states; it was set at 33.3% in 1993, with a reduced rate at 15% for profits under a threshold. Despite a downward trend, taxes were increased twice during the 1990s, in 1995 and 1998. Finally, since 2000 firms pay a "social contribution on profits". It remains that although the tax rate is among the highest in the EU, its proceeds and efficiency are among the lowest: the many abatements and exemptions that exist have considerably reduced the tax base (Jacques Le Cacheux 2008).

Third, in June 2013, the Ayrault government planned a reform of the family quotient that will start impacting tax receipts in 2014. The family quotient (FQ) represents the units of a fiscal household (or fiscal unit). For instance, a couple has a FQ of 2, and an individual taxpayer with a child forms a fiscal unit with a FQ of 1.5. The FQ ceiling will be reduced from 2,000 to 1,500 €. The FQ ceiling represents the maximum abatement that a fiscal unit with children can achieve. This reform will bear on top-income fiscal units and is meant to yield an increase in tax receipts of 1.3 billion € per year. The reform will change the distribution of income taxes between top-income and low-income fiscal units, at the expense of the former.

Since 1999, successive governments have also taken measures to *cut* taxes. Under the Jospin government, the local business tax and employers' social contributions were reduced. As far as households were concerned, they benefited from the decrease in the top-marginal rate of the personal income tax, as well as from the crea-

tion of both an earned income tax credit (part of in-work benefit schemes) and the modification of the local income tax for poor households. This government also awarded a targeted reduced rate for real estate investments. As for the Raffarin and De Villepin governments, they lowered the income tax rate. After three years of constant decrease (from 2002 to 2004), the following Law of Finances enforced a pause in tax decrease. The necessity to curb the public deficit, to pass under the 3% of GDP ceiling of the SGP, has been the major explanation for this sudden stop. The Fillon government in 2007 enacted the already mentioned "tax shield". This cap on households' taxes was later abandoned during the same legislature. Finally, the Ayrault government decided upon a joint reform of the VAT (already mentioned above) and social contributions. While the first will be increased in 2014, the second will be decreased, hence giving rise to a "quasi-social" VAT. A competitive devaluation might ensue, under the provision that domestic firms pass the lower social contributions on their production prices (before VAT is applied) and foreign firms do not modify their mark-ups or production costs to compensate for higher prices including VAT. According to Heyer, Plane, Xavier Timbeau (2012), the "social VAT" reform will have a minor impact on French GDP, employment and exports, because they expect that French firms will not pass the reduction in social contributions onto their prices. Also, comparison with a similar reform in Germany in the 2000s, leads to guess that the impact of the reform in France would even be negative on GDP and employment, following an increase in consumer prices.

1.4 What Do We Learn from Public Deficits?

The trends of public spending and tax receipts in France have led to relatively substantial deficits since the late 1980s (Figure 3). The real crises of the early 1990s and late 2010s pushed deficits at unusual heights, i.e. above 6 and 7% of GDP. Even excluding these peaks, the average public deficit in France since 1987 has been 3.2% of GDP. Quite interestingly, public deficits have frequently hit or exceeded the limit authorized by the Maastricht criteria and the SGP.

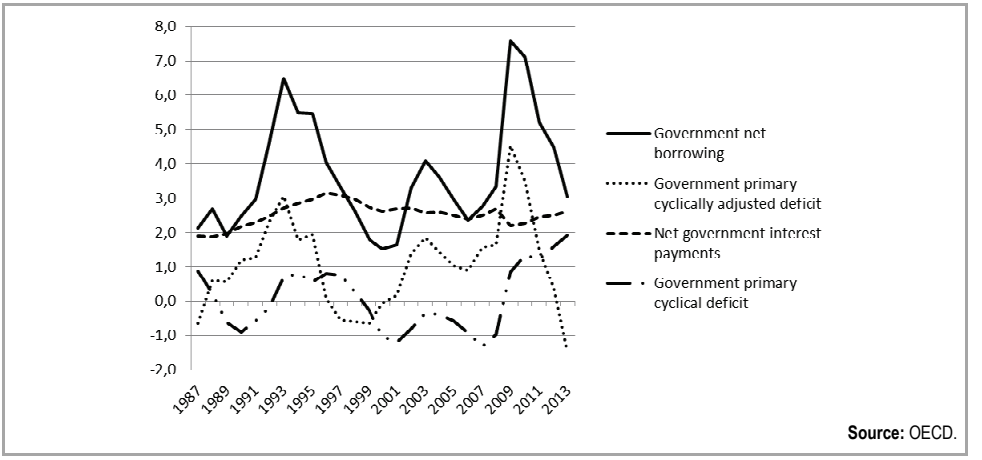


Figure 3 Public Deficits, in % of GDP

The regular high-level of French public deficits, in relation to the European so-called "norms" on "adequate fiscal rules" (see Jean-Paul Fitoussi and Francesco Saraceno 2008), has certainly reduced the margins for maneuver when the global financial crisis happened. Between 2008 and 2009, the deficit rose by 4.2% of GDP, one point more than in Germany. However, German deficit in 2009 barely hit the 3% limit, whereas France largely exceeded it. Consequently, and under the auspices of European fiscal rules, French governments had to limit *early* and *steeply* their public imbalances, hence producing a sharp fiscal contraction. Between 2010 and 2013, the deficit was initially expected to decrease by 4.2 % of GDP, hence erasing the previous crisis-related surge. Nevertheless, this expectation has been revised at the beginning of 2013. In July 2013, France forecast to return below the threshold of 3% not before the 2015. The Commission and the other European governments *de facto* accepted this delay at the end of May 2013.

Two main reasons explain that the fiscal deficit will be close to 3.7% of GDP in 2013. First, GDP growth forecasts are gloomy, not only in France but also in the Euro Area and the EU, the two main trade and financial partners of France. Gloomy prospects mean that tax bases will be lower and social spending higher than initially expected, hence the upwards revision in deficit. Second, revised fiscal multipliers by the IMF (see International Monetary Fund 2012; Olivier Blanchard and Daniel Leigh 2013) have revived attention on the non-linearity of fiscal multipliers *vis-à-vis* the values of the output gap. Indeed, a few papers (Jérôme Creel, Heyer, and Plane 2011; Alan Auerbach and Yuriy Gorodnichenko 2012; Nicoletta Batini, Giovanni Callegari, and Giovanni Melina 2012; Brad de Long and Lawrence Summers 2012) show empirically that fiscal multipliers are stronger under recession and slow growth than at full employment. These studies highlight that what fails in theory (fiscal contraction) also fails in practice. Although these results had no influence on policy decisions yet, they have on the assessment of their consequences, hence on macroeconomic forecasts.

The preceding paragraph has linked public deficits to economic growth. It is certainly also important to draw attention to the composition of the deficit, that can be split into three components: first, net interests paid on past public debt; second, the primary cyclical deficit and, third, the primary cyclically-adjusted deficit. The latter is the most discretionary component of overall deficit and can be used to gauge the fiscal stance. Measuring the cyclical and cyclically-adjusted components of public deficit remains an open issue, mainly because it is based on the output gap and, consequently, on the assessment of "potentional output" and an equilibrium rate of unemployment. Computing a Non-Accelerating Inflation (Wage) Rate of Unemployment (NAIRU-NAWRU) is a tricky issue. In Figure 3, we do not compute our own estimates of the NAIRU, the output gap and cyclically-adjusted fiscal balances. Rather, we use the data from the OECD for the primary cyclically-adjusted deficit. This indicator is netted out of net interests and depends on the elasticity of the public deficit *vis-à-vis* the output gap. The elasticity and the output gap have been computed by the OECD. To compare the different components of public deficit, we present the primary cyclically-adjusted deficit in % of GDP, whereas the OECD presents it in % of potential GDP. We also compute the primary cyclical component as a residual

between the overall deficit, on the one hand, and the sum of net interests and the primary cyclically-adjusted component on the other hand.

Figure 3 reports the cyclicality of the primary cyclical part of the deficit: the average primary cyclical deficit has been 0.1% of GDP since 1987[5]. This is not surprising over a sufficiently long-time span that has witnessed good and bad times. Nevertheless, Figure 3 also reveals that the largest primary cyclical deficits have rarely exceeded 1 percentage point of GDP. Therefore, on average or on a time-to-time basis, the main culprit for large public deficits in France is not the cyclical component.

We are thus left with two other culprits: the discretionary stance and net interests. The first one is under the responsibility of current governments whereas the second is the result of past accumulated deficits and past and current long-term interest rates. If one excludes the recession years, the discretionary stance accounts for 0.7 percentage points of GDP. Peaks at 3% and 4% in 1993 and 2009-2010 drive this average at 1.1% of GDP, for an average overall public deficit at 3.7%. Though this is not a minor contribution to the deficit, the discretionary stance does not explain the major part of the French public deficit.

Figure 4 reports the contributions to the public deficit of the three already mentioned components. It appears clearly that except under recessions, the largest part of the French deficit stems from net interests. In sharp contrast with the remaining components, net interests have been very stable in proportion to GDP since 1987 (see Figure 3).

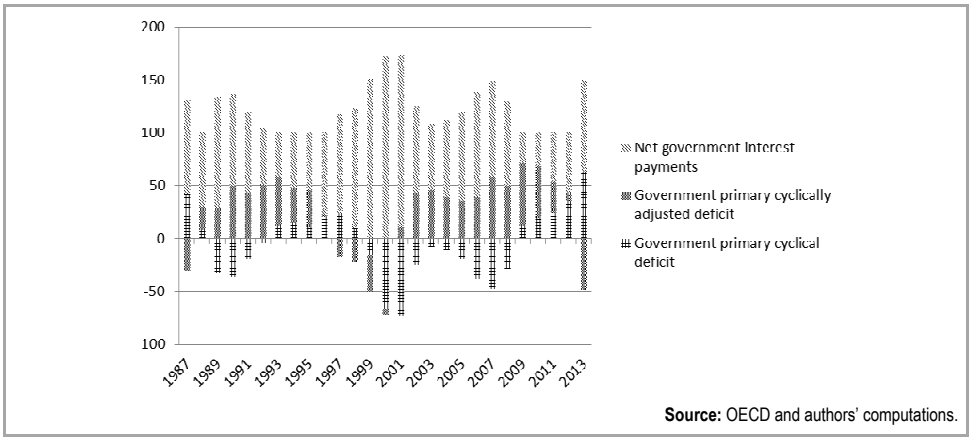


Figure 4 Contributions to Public Deficits, in %

Figures 3 and 4 also show that the fiscal adjustment since 2010 has been a pure fiscal contraction in the sense that it happened through the discretionary stance, whereas the cyclical component and net interests' contributions to the deficit grew. The contribution of the fiscal stance to the deficit was almost nil in 2012 and negative in 2013 despite the on-going Euro Area sovereign-debt crisis. This pure fiscal

[5] The average is 0 % of GDP when recession years are excluded.

contraction has been of an outstanding amount of close to 6 percentage points of GDP between 2010 and 2013.

If no political change in the interpretation of European treaties and laws by French governments does occur, the margins for maneuver to consolidate further French public finances will depend only on net interests; hence on debt issuances' management, and on the return of economic growth, which would alleviate the deficit and debt's burden[6].

2. The French Government Debt

The different trends in spending and tax receipts that were described in the previous part have had strong consequences on the level, but also on the composition of public debt in France. Public debt was a non-issue in France before the 1990s and ever more so before the 1980s. But since the Maastricht treaty was signed, public debt has become a major political and economic issue.

2.1 Evolution and Composition of Debt

France's government gross debt has increased significantly over the past two decades. In 1993, government debt was 51% of GDP, while in 2013 it was 107% of GDP (or 93% of GDP according to the gross public debt Maastricht criterion that consolidates parts of general government, central, local governments and social security). Government debt has increased significantly during two periods: 1993-1998 and 2007-2013. While the government budget has not been in surplus since 1974, these two periods share a common characteristic: recession and slow economic growth. Both impacted on cyclical deficits but also on interest charges, hence on debts, because monetary policy, quite certainly in the 1990s, and to a lower extent over the most recent years, has not been sufficiently accommodative to offset the real costs of recessions.

The French government debt can be decomposed in two different types of liabilities: long-term securities and short-term loans which together represent more than 85% of the total. The management of French debt and its instruments has evolved over the past 15 years. While in 1996 the amount of securities represented 3 times the amount of loans, the ratio increased substantially to 8 in 2011 with 1600 billion € of securities and 200 billion € of loans. The reduction of long-term interest rates over the period has played a role in encouraging the government to favour long-term securities. Moreover, the development and deepening of financial markets during the same period have allowed the issuance of more securities. Public debt management has gone hand in hand with the financialisation of the French economy that was accompanied by a strong market orientation of banking activities (Christophe Blot et al. 2012). Increased bond market capitalization substantially improved liquidity and made it possible for the French government to seek for better financial conditions.

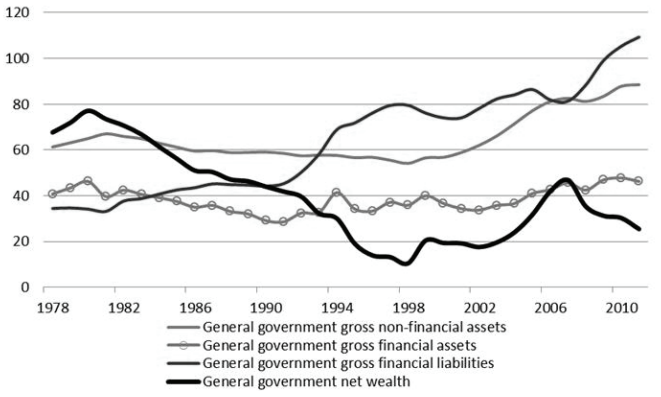
[6] Nominal growth in France between 2008 and 2013 has already helped to curb the deficit-to-GDP and debt-to-GDP ratio. Over this period, nominal GDP grew by 6.5 per cent. In contrast, Spain underwent a fall of 3.4 per cent. The resilience of nominal growth in France has certainly helped to maintain the sustainability of French public finances.

2.2 Gross versus Net Debt

The evolution and level of sovereign debts is usually exclusively analysed at the level of gross debt, which appears quite irrelevant since it gives no indication on the use of this debt. If debt has been used to acquire assets with high capital gains or with higher returns than the cost of debt, then looking solely at gross debt levels is misleading.

Since the beginning of the 1980s, the general government net wealth has been considerably reduced, from almost 80% of GDP in 1980 to 25% of GDP in 2011 (Figure 5). This trend was mostly explained by the surge of gross liabilities under a stable provision of non-financial assets, at least until 2002 when the value of the latter also increased.

Overall, in the case of France, despite the increase in gross debt that we already mentioned, the net wealth position of the government has always been positive since 1978. What is more, from the late 1990s to the beginning of the crisis, it actually *increased*.



Source: OECD and INSEE.

Figure 5 French Government Net Wealth, in % of GDP

The general government net wealth nets out liabilities with non-financial assets. The values of these non-financial assets, like roads, water facilities, education building, etc., are certainly difficult to assess (see the seminal contribution by Robert Eisner and David H. Nebhut 1982). As a matter of fact, the flow of revenues that public infrastructures will produce is very uncertain and remains an open issue. Hence, the question of the sustainability of public finances is fettered by the lack of instruments to gauge future streams of revenues and costs stemming from public infrastructures.

For this reason, net public debt is usually used as an intermediate indicator of net government financial assets/liabilities, between gross debt and general government net wealth. In contrast with the latter, net public debt is gross public debt netted out of financial assets only. Contrary to non-financial assets, values of financial assets are market-related. Nevertheless, prices may include noise when booms or busts

on financial markets are under way. Despite its potential drawbacks, net debt gives a more precise picture of the State financial position than the purely liabilities-related gross debt.

As mentioned, France had no issue with net public debt until the early 1980s (Figure 6). Indeed, net public debt was negative in 1980. However, the 1980s and early 1990s produced a sharp increase in net public debt which went above 40% of GDP in 1995. After a cyclical evolution around this value until 2008, the ratio jumped rapidly above 60% of GDP. Consistently with gross debt data, the steepest rise in the net debt-to-GDP ratio occurred during recessions. Between 1999 and 2006, France's net debt was below the Euro Area average but since then, France has overtaken it.

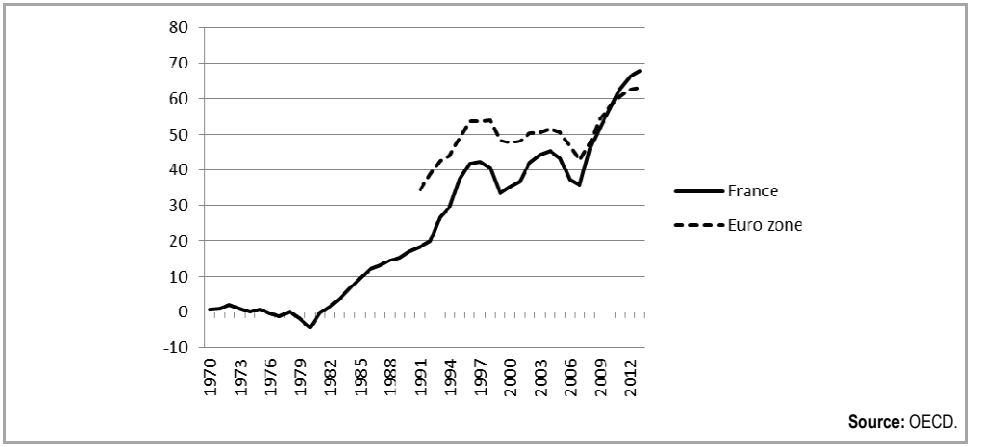
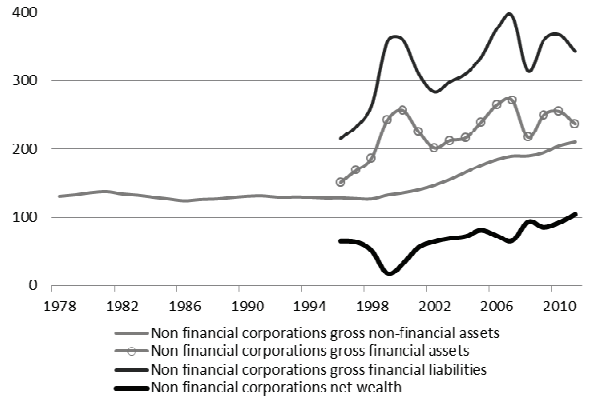


Figure 6 French Government Net Debt, in % of GDP

2.3 Public versus Private Debt

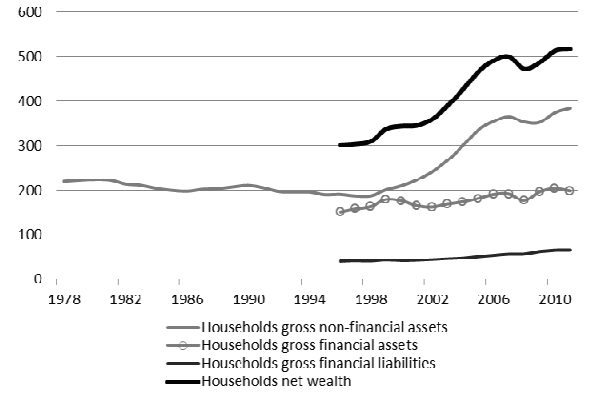
Going back to gross debt data - the European Commission monitors public debts assessed in gross rather than net terms - it is interesting to analyse and compare non-financial corporations' and households' balance sheet expressed in the same manner. Notwithstanding the amounts of private assets, a focus on the sole public debts is misleading: there may be countries with high public debt and low private debt which overall sustainability would not be at stake, and countries with high public and private debts that would need to rely on to external financing, hence producing a potential risk of unsustainability.

In France, the levels of gross private debt are substantial, notably in comparison with the gross public debt to GDP ratio: the gross debt of French non-financial corporations was 343% of GDP in 2011 while the gross debt of households was 66% of GDP. Figure 7 shows that the rise in non-financial corporations' gross financial liabilities was very sharp in the mid-1990s and then, during the 2000s until the global financial crisis started. In contrast, households' debts have been very stable in proportion to GDP since 1995 (Figure 8).



Source: INSEE.

Figure 7 Non-Financial Corporations' Net Wealth, in % of GDP



Source: INSEE.

Figure 8 Households' Net Wealth, in % of GDP

In the case of firms and households, one is certainly more used to looking at the assets' side in front of the liabilities' side because they are generally associated with production, investment and consumption. As governments are also involved in these activities, it should be standard practice to assess balance sheets through net wealth for all economic agents, be they private or public.

Indeed, the picture of balance sheets of households and firms is no less striking than the government's if one focuses on net wealth rather than gross debt. Net wealth positions of non-financial corporations and households have been positive since 1995 (first year of available data) and they were equal to 104% of GDP and 517% of GDP respectively in 2011. One major difference between the private sector and the government net wealth is its recent evolution: between 2007 and 2011 it increased for the former but it decreased for the latter. The gross liabilities of the

households did not grow as much as governments' whereas non-financial corporations have seen gross assets and liabilities grow hand in hand; meanwhile only liabilities were growing for governments.

2.4 Government Debt Financing

The growing size of public debts has raised the issue of the rise in interest payments that may burden the French public deficit. Implicitly or explicitly, observers worried about crowding out. However, skilful debt management has so far been made possible to match the needs of investors and issuers, and also to adapt the maturity of debt to the yield curve, so that nominal rates would be set at a minimum.

Indeed, despite a small decrease since the mid-1990s, net interests still represented 2.5% of GDP in 2012, and as we saw above they have been rather stable over time. Therefore, they limit the scope for fiscal stimulus in the EU where public deficits are capped at 3% of GDP. Nevertheless, the stability of net interest rates (in proportion to GDP) during a period of growing debts opposes the crowding-out effect argument.

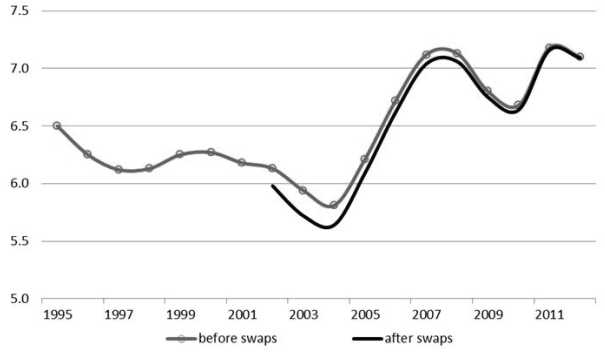
The average maturity of the French government debt has been around 6.5 years for the last two decades (see Figure 9). However, one can note on Figure 9 that while this average maturity had tended to decline until 2003 - to reach a minimum at 5.75 years - it increased sharply over the past ten years and is in 2012 around 7 years. The Agence France Trésor (AFT), created in 1999 and whose mission is to manage the debt and cash of the French State in the best interests of the taxpayer and the best security conditions, regularly issues at all maturities of the yield curve to get the best liquidity and to reduce risks, including the volatility of the debt burden and the refinancing risk. Its portfolio policy has resulted in an increasing average debt maturity. In this respect, France is well positioned in terms of average maturity; it is much longer than the United States (4.3 years) and slightly higher than in Germany (6.6 years); only the United Kingdom has a much longer maturity, certainly because of the importance of pension funds in this country whose demand for long-term securities is naturally driven by regulation[7].

The reliance of AFT on more sophisticated financial products, like swaps, has not fundamentally modified the average maturity of public debt. The average maturity was significantly reduced only after these swaps were introduced, hence between 2002 and 2004. In 2012, maturity was similar with or without swaps.

Despite the strong increase of the French government debt over the past 6 years, interest payments have paradoxically changed little over the same period of time (Figure 10). After a period of increase together with the government debt until the mid-1990s, they remained stable during a decade to increase again recently, but at a smaller pace than the underlying debt. This is related to the sharp decline in interest rates over the past 20 years, from 7% to 2.5%. The decline in inflation from the early 1980s was indeed followed by a decline in global interest rates, in an environ-

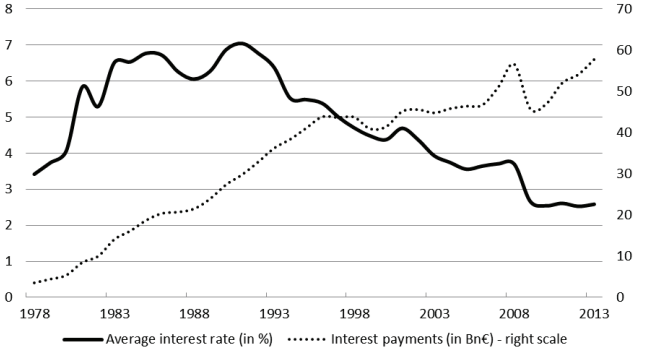
[7] Despite reforms, the French pension system is still dominated by a compulsory PAYG scheme. The attractiveness of French public debt is circumscribed to foreign pension funds, in contrast with UK public debt.

ment where economic agents expected more permanent low inflation. This rate decline was amplified in the case of France, thanks to the disappearance of risk premia following the adoption of the euro. This development has been very supportive to public finances.



Source: Agence France Trésor.

Figure 9 Average Maturity of French Debt



Note: The average interest rate is computed as the ratio between interest payments and government gross debt for each given year.

Source: OECD and INSEE.

Figure 10 Average Interest Rate of French Debt

To give an idea of the impact of low interest rates, had the average interest rate in 1990 been applied to the 2011 debt, interest payments would have equalled 156 billion € against 58 billion € today. This illustrates the room for manoeuver enjoyed by the French government thanks to low interest rates. However, the margins have been exhausted: the long-run interest rates will not remain permanently below the growth rate of the economy once the global financial crisis and its sequel, the European sovereign debt crisis, will be over. The Eurozone crisis, thanks to monetary easing and the "flight to quality" of foreign investors running from peripheral economies, has induced a further decline in interest rates since 2009. A potential risk now

is that due to the relatively high level reached by the French government debt, investors require higher returns. However, this risk has not yet materialized since the crisis has led, at the opposite, to a strong demand for government securities, which appeared safer than private ones. Recent debt issuances in France have been achieved at historically low interest rates.

The attractiveness of French public debt for investors can also be perceived *via* the bid-to-offer ratio. From 1999 to 2012, the demand for French public debt has always exceeded its supply, and the bid-to-offer ratio has been 2.85 on average. The same ratio has been 2.55 since November 2009 and the starting point of the sovereign debt crisis, and the "flight to quality" resumed in 2012 when the bid-to-offer ratio reached 2.71.

3. Summary and Conclusions

We traced the evolution and composition of French government revenues and spending since the 1970s. We looked at the structure of public debt (composition, average maturity, interest rates). Our conclusion is that there is no serious reason to worry about sustainability, even if French public finances can certainly be improved in terms of fairness and efficiency. At least three elements have facilitated fiscal sustainability. First, the discretionary fiscal contraction which we observed has substantially reduced the deficit-to-GDP ratio and slow-downed the debt-to-GDP ratio. Second, and despite the real cost of austerity, positive nominal GDP growth has helped to limit recourse to public deficits. Third, public debt management has been successful if one looks at the long-term interest rate on public bonds or at the gap between demand and supply for bonds. Interest rates have been low and demand has remained strong despite growing indebtedness.

The developments of French public finances show that, although debt and deficit have increased during the crisis, the situation is not dramatic. Consequently, we question the relevance of implementing stringent fiscal rules whose negative impact on economic growth will likely be strong in the future. We showed elsewhere (Creel, Paul Hubert, and Saraceno 2012, 2013) that more stringent fiscal rules, like the Fiscal Compact, would impose a real cost on the French economy that other fiscal rules, equally sustainable in the long run, would not impose.

Our analysis allows drawing policy recommendation for the French government. Regarding the composition of deficits, it is important to raise the basis for the income tax and to limit the number of exemptions, so that a more progressive and fairer tax system for households can be put in place. This reform would improve the efficiency of the tax system in that it would reduce inequality. Otherwise, growing inequality in France may produce social unrest and economic instability.

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