By the Rule

In France, a commission proposes a rule-based framework to set the country on a path to balanced budgets

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FRANCE, facing the same unsettling long-term fiscal prospects as most advanced economies, set up a high-level working group in early 2010 to design a rule-based framework for fiscal consolidation to achieve the public budget balance that was enshrined in the French Constitution in 2008.

The working group, chaired by former IMF Managing Director Michel Camdessus, had 15 members: four from Parliament, seven top-ranking civil servants (including Banque de France Governor Christian Noyer), and four academics.

There is more to achieving debt sustainability—that is, bringing down deficits and debt ratios to prudent levels—than merely winding down the stimulus that France undertook during the recent economic crisis. Like other advanced economies, France will have to cope in future budgets with the rising pension and health costs of an aging population (see "The Long Run Is Near" in this issue of *F&D*). While part of the policy response will come from the major overhaul that the French pension system is undergoing, the rule-based framework proposed by the working group should be a critical complement.

Rules play a role in instilling fiscal discipline in France. They include the *Stability and Growth Pact*—the European Union–wide agreement that caps deficit and debt levels—and a set of expenditure rules at the national level that prohibit general government current spending from rising in volume year over year.

However effective, though, expenditure rules "are not linked directly to the debt sustainability objective since they do not constrain the revenue side," according to a recent paper (IMF, 2009) the working group took into consideration. The working group aimed to join the missing links in the existing rules framework, by designing a comprehensive rule that would bind policymakers to medium-term objectives and provide operational tools to undertake the required fiscal adjustment.

The key provision is designed to ensure that the budget acts passed year after year are consistent with reaching the ultimate target of a balanced budget. To achieve that objective, the working group suggested that lawmakers commit to a mandatory multiyear framework for budget programming, which would bind future yearly budget acts by setting *milestones* those budgets would have to meet to reach eventual fiscal adjustment.

The fiscal rule, though, must be flexible enough to respond to shocks and allow the government to avoid policies that push in the same direction as the business cycle. Each milestone could typically be defined in terms of structural balance—in which expected revenues and expected spending match up. But there are hurdles to this approach. First, the structural balance is an estimate, not a firm number. It relies on computation of the *output gap*—the difference between what a country could produce and what it actually produces. Moreover, revisions of estimates of gross domestic product in earlier periods could affect current output gap estimates. Such after-the-fact revisions can jeopardize the very ability to comply with the rule in a time-consistent manner.

Second, estimating revenue elasticity—how taxes respond to changes in the business cycle—can be challenging. As noted in the IMF paper, "an important issue relates to the impact of cycles in corporate profits and asset prices on revenues, which may not be adequately captured by changes in output. The magnitude of this impact can be significant, and in principle should be taken into account. In practice, however, adjusting for these effects is challenging and has seldom been systematically undertaken."

So the working group suggested isolating the *nondiscretionary* component of the change in the structural balance—that portion of spending and revenue over which legislators have no control—including the impact of volatility in tax revenue elasticity. Conversely, the scope of the rule would encompass government revenues and spending over which *discretionary* policy and management have an influence. This scheme echoes earlier works by Duchêne and Lévy (2003) and Guyon and Sorbe (2009), from the French Treasury.

To lawmakers, the rule would be binding on what they can control. Matching controllability by policymaking and accountability of policymakers should foster appropriation and enforcement of the rule. For the rule to focus on the discretionary component of the change in the structural balance, not only should factors over which lawmakers have no control be isolated, but so should items that depend on the business cycle—commonly known as *automatic stabilizers*. According to the Stability and Growth Pact, automatic stabilizers include tax revenues and unemployment benefits. These items would then fall outside the scope of the rule. However, fine-tuning of tax revenues can still be considered: whereas the year-over-year change in the amounts collected from taxpayers on the basis of established applicable law cannot be deemed the result of policy decisions, the same is not true of amendments to legislation, which affect government revenues, other things being equal.

To target discretionary structural measures comprehensively, the binding milestones must apply both to the net cost or the revenue of newly enacted tax law and to all government expenses except unemployment compensation. This captures, in structural terms, the policymaking action to put consecutive budgets on the path to balance.

The rule should bind not only yearly budget acts, but also the implementation of the budget and response to deviations from the budget. A procedure would be set up to monitor execution, with the aim of detecting early on any significant slippage during the budget year: specific amendments should then return the budget to its predefined path. If deviations are detected at the end of the year, the working group suggests automatically tightening the numerical milestones applicable to future budget acts.

Commitment by authorities is key to the credibility, effectiveness, and sustainability of the rule. The working group included the chairs and chief sponsors of the budget committees of the National Assembly and the Senate—that is, members from the majority as well as the minority. They unanimously favored enshrining the proposed rule in higher-level legislation, showing that they share an awareness of the challenges ahead, a sense of duty, and a willingness to act.

A fiscal responsibility law enacted by the French parliament in 2001 had already gathered wide support. By strengthening its set of rules, France will give clear evidence of its commitment to fiscal consolidation and discipline. ■

Michel Camdessus, a former IMF Managing Director, chaired the fiscal consolidation commission and Renaud Guidée served as its Secretary-General.

References:

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