France: will enhanced governance framework for public finances improve fiscal credibility?

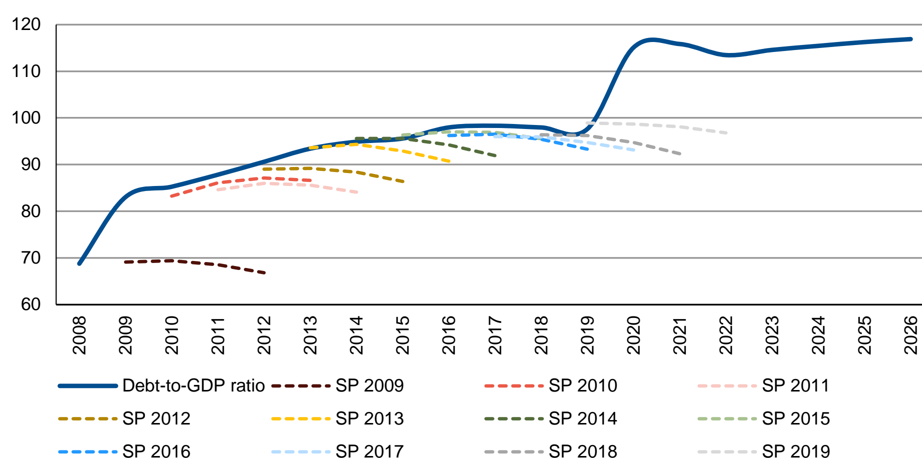
Scope Ratings

France (AA/Stable) has a weak record of fiscal consolidation, reflected in elevated public debt, constant primary deficits and high, rigid public expenditure. Over recent decades, successive governments have failed to reduce debt-to-GDP, despite repeated commitments to improve budget controls, raising doubts about the country's fiscal credibility. Ahead of this month's presidential and legislative elections, we explore the implications of the recent changes in France's fiscal governance framework for the credit outlook.

Since the 1980s, France has never achieved a balanced budget and its public debt has steadily increased with only brief periods of stabilisation or modest reduction in indebtedness, while consolidation targets have repeatedly been missed (**Figure 1**). More recently, the impact of the Covid crisis has pushed public debt to record highs and will have long-lasting consequences for the country's fiscal fundamentals. Pressure on public finances could be exacerbated further in the context of gradually rising interest rates, rigidities in public spending, the need for more public investment and weakening economic growth.

Given this challenge, it is critical that France designs and effectively implements an ambitious consolidation strategy that will strengthen fiscal credibility. To this end, the government has adopted a bill to introduce a revamped expenditure rule and increase budgetary transparency and accountability. But how significant is this reform for France's fiscal framework?

Figure 1. France's deviation from long-term fiscal consolidation targets
% of GDP



Note: Stability Programme (SP); baseline debt projections presented here for 2022-26 are taken from the IMF WEO.
Source: IMF, Scope Ratings

The main conclusions from our analysis are:

- France introduced in 2021 an enhanced governance framework for public finances in response to years of budget deficits and rising public debt, which have set it apart from the euro area average.
- This framework makes the stabilisation of debt more likely as it improves transparency and accountability, but it falls short of the sort of constraints on excess government spending in place in Nordics and Germany, which have binding rules.
- The capacity of the incoming president to implement structural economic reforms to boost France's growth potential and bring down debt-to-GDP will be critical, given little political or popular appetite for spending restraint, judging by the pre-election debate.

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Enhanced governance framework for public finances to make the stabilisation of debt to GDP ratio more likely…

New reform to the fiscal framework through…

France adopted a law reforming the framework in December 2021, almost a decade since the previous reform of the country's fiscal framework. The law focuses on three main aspects: i) improving the country's multiannual management of public spending and debt through reinforced expenditure targets; ii) enhancing budgetary transparency and accountability; and iii) reinforcing the supervisory powers of parliament and the *Haut Conseil des Finances Publiques* (HCFP).

…a revamped, though not binding, expenditure rule…

National multiannual public finance programming laws, which set the medium-term budgetary objectives, will from now on introduce precise targets for total public expenditure in nominal terms and in real growth terms, which come on top of already existing sub-targets for various layers of administration (i.e., the state, social security, local and regional authorities). France's fiscal framework will thus focus on the trajectory of public spending rather than the trajectory of the structural balance as it is currently the case. Importantly, any deviation from the pre-agreed multiyear targets will have to be formally justified by the government to the HCFP.

We view the strengthening of multi-year programming of public spending as a positive development since it brings a clear response to an unaddressed fiscal challenge and could make the government more sensitive to public expenditure. It gives the government guidelines for its fiscal decisions and the increased focus on expenditure, rather than the structural balance, is in line with growing consensus among economists which advocate for similar approaches at the EU level[1]. Research by the European Commission has shown that national expenditure rules reduce the pro-cyclical bias of fiscal policies in the EU and strengthen expenditure control[2].

Yet, the degree to which these expenditure targets are binding is limited by the principal of *annualité* embedded in the French Constitution, which in theory gives the Parliament the right to vote budgets that exceed the targets, as we have seen for expenditure objectives which are already in place. This contrasts expenditure ceiling frameworks in countries like Sweden, Finland or Denmark for instance where ceilings are more legally binding. In that sense, the framework is close to the one in the UK where forward looking targets could change over time, depending on government budget announcements. Furthermore, France's enhanced governance framework does not set a binding fiscal rule, as is the case in the Nordics or Germany with its debt brake, ensuring that France's deviation from initial fiscal targets remains a real possibility.

… more budgetary transparency and accountability…

Beyond multi-year targets, other provisions have also been introduced. Yearly budget bills will from now on clearly state the distinction between operating and investment spending before a parliamentary vote. In addition, the parliament will have an increased capacity for policy evaluation thanks to an extension of the period of examination and a dedicated parliamentary session on the public debt, its trajectory, its financing conditions and long-term sustainability. Overall, higher public accountability surrounding fiscal outcomes and debt developments will thus contribute to the strengthening of fiscal credibility.

…broadened powers for the French Fiscal Council

Finally, the mandate of the HCFP has been broadened, which is welcome as it constitutes the main supervisory body. It will now pass judgment on the credibility of the government's revenue and spending projections rather than just its macroeconomic assumptions. In addition, the HCFP will provide assessments of sector-specific financing laws which can

[1] See IMF (2015), Expenditure Rules: Effective Tools for Sound Fiscal Policy?; Darvas and Anderson (2020), New life for an old framework: redesigning the European Union's expenditure and golden fiscal rules; Martin, Pisani-Ferry and Ragot (2021), A new template for the European fiscal framework

[2] European Commission (2020), National Expenditure Rules in the EU: An Analysis of Effectiveness and Compliance

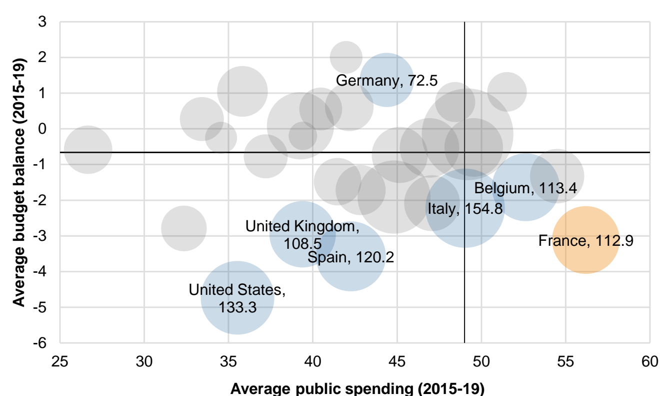
impact the public finance outlook. Still, the remit of the HCFP is narrow compared with the fiscal councils of some other euro area countries. It is not tasked with evaluating new revenue or expenditure measures nor with providing its own debt sustainability analysis, unlike Germany, Italy, and Spain for instance.

…as spending-based consolidation becomes critical for effectively addressing France's fiscal vulnerabilities…

Chronic fiscal deficits led to sizeable public debt build up

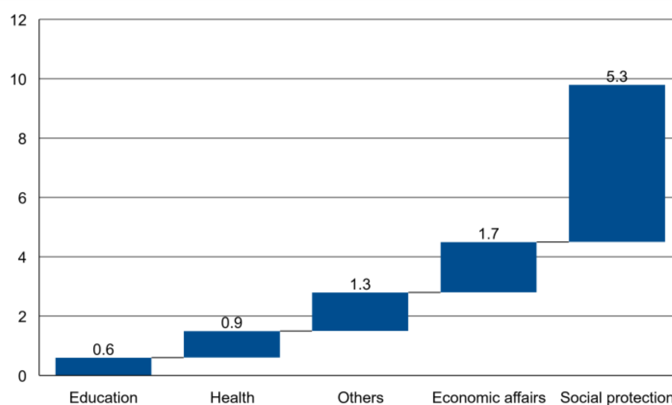
France's public finances are characterised by elevated public debt-to-GDP, wide primary deficits, high expenditures, and a poor fiscal consolidation record (**Figure 2**). Since the 1980s, the fiscal balance has been continuously in deficit, which has led to a sizeable build-up in public debt, exacerbated by the recent Covid crisis. France's public debt reached 112.9% of GDP in 2021, up from 97.4% in 2019.

Figure 2. France's fiscal fundamentals versus rating peers
% of GDP



Note: The bubble size and label figures refer to the 2021 public debt-to-GDP ratio.
Source: IMF, Insee, Scope Ratings

Figure 3. France's public expenditure versus the EU average
pps of GDP



Source: Eurostat, Scope Ratings

Elevated public spending…

France's public expenditure is among the highest in the world, totalling 56% of GDP in 2019, 9.8pps higher than the EU average. France's public spending is consistently higher than EU peers by relatively small margins for most components, except economic affairs (+1.7pps) and particularly social protection spending (+5.3pps) (**Figure 3**). Spending dedicated to France's welfare state is structurally more generous and protective than in other advanced economies, which can be a source of long-term fiscal pressure.

…high public investment …

France's public investment spending has run above the OECD average and levels for selected euro area countries in recent years (**Figure 4**). Over 2015-19, French public investment averaged 3.5% of GDP, against 3.2% for OECD countries on average. The practice should support long-term GDP growth if spent wisely.

However, long-term investments have been delivered on top of high current expenditures. Structurally high public expenditure in a country with an already elevated tax burden presents a fiscal risk, since additional and sizeable public investments will be required to address multiple long-term challenges such as the climate transition, digital transformation, ageing population and rising geopolitical tensions, underlined by Russia's war in Ukraine. For instance, the government has committed to re-investment in nuclear energy, equivalent to EUR 50bn according to initial estimates.

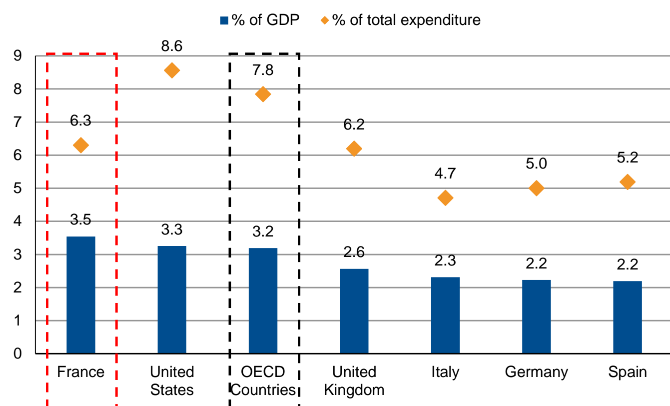
…have exacerbated the gap in public debt ratios vs peers…

Rapid increases in spending during recessions explains the sustained increase in public debt in France only partly reversed or offset by revenue increases during periods of economic recovery. The structural weight of public spending in France - the ratio of

cyclically adjusted spending relative to potential GDP - has fallen only one year in three, compared with an average of one year in two in the rest of the EU (**Figure 5**).

Figure 4. Public investment, 2015-19

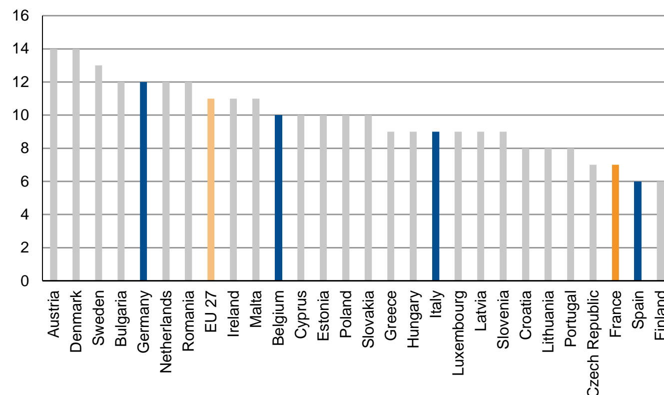
% of GDP



Source: OECD, Scope Ratings

Figure 5. Number of years in which cyclically adjusted expenditure ratios were decreased, 2000-2019

Years



Source: European Commission, Scope Ratings

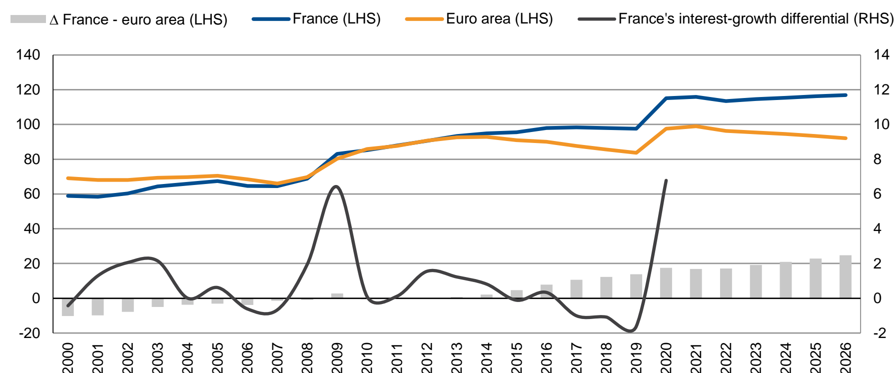
…despite record-low interest rates

This has led to a structural widening in the gap of France's public debt ratio with that of the euro area average since mid-2010s. IMF forecasts show that this gap could increase further to reach up to 25pps of GDP by 2026 (**Figure 6**).

The continuous rise in France's public debt-to-GDP ratio occurred despite the positive effects of the highly accommodative monetary policy of the ECB. During 2014-19, the difference between France's interest rates and GDP growth turned negative, for the second time in 20 years, but the country failed to make use of resulting favourable circumstances to stabilise or even reduce public debt. The window of opportunity of negative interest rate/growth differentials may be coming to an end given recent inflationary pressures and the expected gradual rise in euro area interest rates, unless nominal GDP growth increases significantly, which will require forceful structural reform. Rising inflation could have a positive though limited impact on the debt trajectory.

Figure 6. France's diverging debt trajectory and interest rate/growth differential

% of GDP, pps



Source: Insee, IMF, Scope Ratings

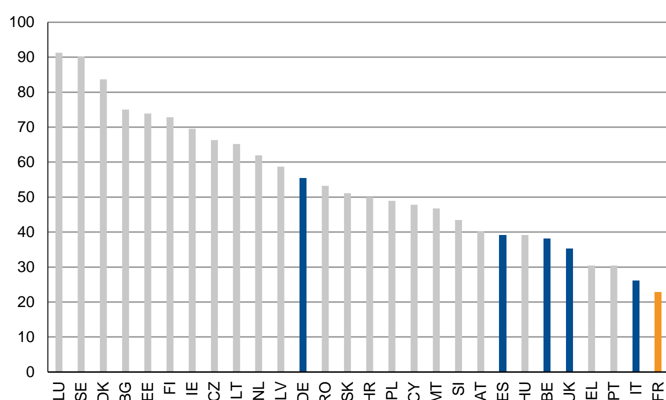
Given these structural trends, the government will have to design and effectively implement a spending-based consolidation strategy to address France's public finance vulnerabilities. This view is broadly shared by major economic institutions such as the IMF, OECD and even non-government entities such as the *Commission Arthuis* or the *Cour des comptes*[3].

…and failure to reach consolidation targets highlights shortcomings in the governance of public finance

Low compliance with European fiscal rules

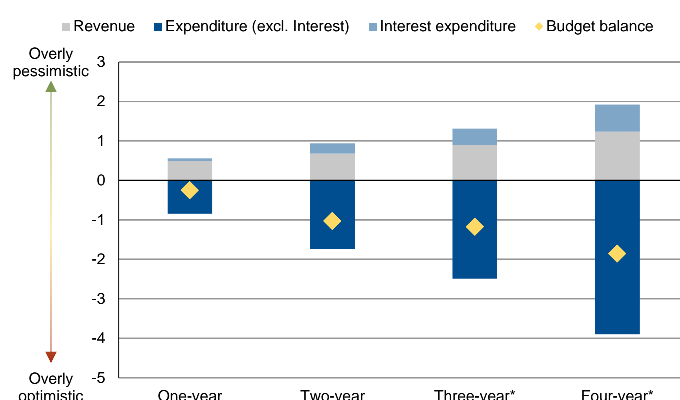
Inefficiencies in France's fiscal framework are reflected in its regular breach of European fiscal rules (i.e., deficit, debt, structural balance, expenditure). France's compliance with these rules over 1998-2020 was the lowest among EU member states, with an overall score of 23%[4] (**Figure 7**). This could be explained by the lack of an appropriate anchor in the domestic framework, as it prevails in some euro area peers, which has enabled various governments to overspend. In that sense, the reform of the European rules, contemplated by end-2023, will be particularly important for France's fiscal stance, including when it comes to the treatment of green, digital, and defence spending.

Figure 7. Compliance with European fiscal rules, 1998-2020
Overall compliance scores, %



Note: Overall compliance scores are calculated as averages over 1998-2020 and the four fiscal rules of the Stability and Growth Pact.
Source: European Commission, Scope Ratings

Figure 8. Bias in budgetary projections, 2009-2018
pps of GDP



Note: Four-year after the adoption of the budget, the budget balance is lower by around 2pps of GDP. * Calculations exclude biases for 2020 and 2021.
Source: European Commission, Scope Ratings

Consistent upward bias in fiscal projections

In line with the Stability and Growth Pact, France is required to design and implement a multi-year fiscal strategy. This multiannual strategy is critical for the sustainability of public finances and for the implementation of reforms to face future challenges such as the green transition or population ageing. However, France's projections as presented in national Stability and Growth Programmes (from the 2009-12 to 2018-22 plans) versus actual budgetary outturns highlights a chronic underestimation of deficits. On average, France's deficit turns out to be around EUR 50bn (2pps of GDP) wider than its 4-year targets (**Figure 8**).

This structural bias results mainly from underestimated public expenditures, despite a lower interest payment burden than expected given favourable market conditions. While governments may have committed to deliver consolidation at the time of budget approval, the implementation of the pre-agreed trajectory has then required ambitious reforms, which have usually faced strong social opposition. To address this, the IMF has recommended

[3] Respectively, a parliamentary commission on public finance and the supreme body for auditing the use of public funds.
[4] The European Commission's Overall Compliance Score measures numerical (as opposed to legal) compliance with the rules of the Stability and Growth Pact and assesses whether in pure quantitative terms the relevant fiscal aggregates – the budget balance, the debt-to-GDP ratio or government expenditure – evolved in line with the main course of action implied by the rules or not.

France to adopt a revamped expenditure rule, which covers the entire general government sector, and also to enhance supervision by the French Fiscal Council (*Haut Conseil des Finances Publiques* – HCFP), which should also provide independent forecasts.

Multiple warnings on the steady increase of public debt

Regular breaches of European fiscal rules, the rise in public debt and failure to adhere to pre-agreed fiscal targets have led various international (i.e., IMF, European Commission, OECD) and national institutions (i.e., *Cour des Comptes, Banque de France,* among others) to point out the steady deteriorating trajectory of France's public finances. Among the main recommendations, these institutions have advocated a reform to the fiscal framework to improve the efficiency of the budgeting process, its transparency, and France's ability to set and achieve long-term fiscal objectives.

Concluding remarks

France's public finances remain key credit challenge

France's public finances constitutes one of the country's main credit challenges. High public spending, low compliance with domestic targets and European fiscal rules, as well as postponed structural reforms have led to an elevated public debt burden, diverging from the euro area average. Against this backdrop, reversing those trends will prove challenging, amid an already elevated tax burden, population ageing, and large public investment needs to deliver on climate and digital transformations. Even so, addressing this credit challenge will be critical to strengthen fiscal credibility and stabilise public debt through the cycle.

Fiscal reforms improve accountability; still non-binding

The recent reform to France's fiscal framework is therefore an important step forward in our view. It lays the institutional ground for a better long-term planning and management of public finances and increases the political accountability of not adhering to pre-agreed fiscal targets for future governments. The introduction of a multi-year expenditure rule applying to the entire general government and increased monitoring by the HCFP will allow the country to better plan and manage its public expenditures. Still, the non-binding nature of the revamped expenditure rule and still lagging supervisory powers of the HCFP remain areas for improvements.

Fiscal consolidation is absent in political debate

Importantly, matching fiscal commitments made by the government through this enhanced governance framework with much needed structural reforms will be essential to gradually rebuild buffers. The fiscal effort required to narrow down the deficit below the 3.0% of GDP threshold will be substantial, around EUR 47bn in savings over the next five years according to the *Cour des comptes*[5]. However, fiscal consolidation has been notably absent from the policy debate in comparison to past campaigns leading up to April's presidential election. Many candidates promise additional spending without systemically matching funding for public finances, raising additional concerns on France's long-term fiscal sustainability, particularly as the growth outlook is weakening.

[5] Cour des comptes (2022), Le rapport public annuel 2022

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