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FRANCE STRATÉGIE

ÉVALUER. ANTICIPER. DÉBATTRE. PROPOSER.

IMPROVING INVESTMENT TO FOSTER GROWTH

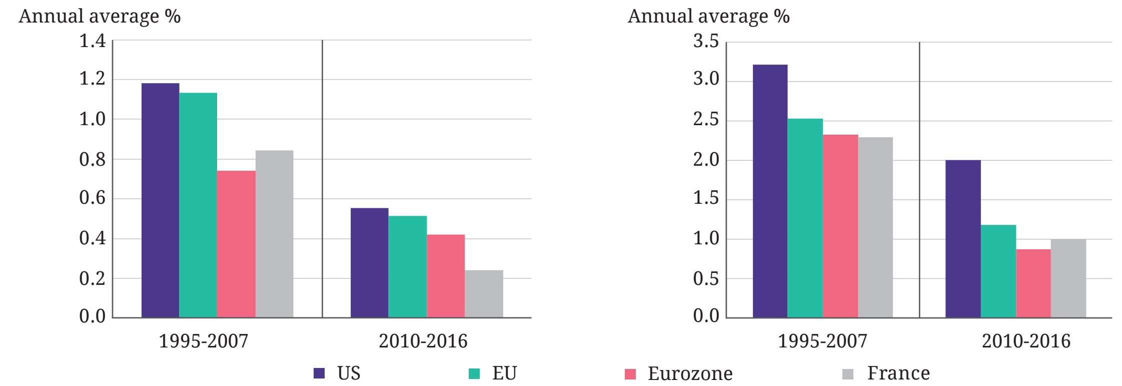
CRITICAL ACTIONS

FEBRUARY2017

Against a backdrop of sluggish growth in Europe and the rest of the world, the French economy is facing weakness on both the demand and supply sides. The risk today is this situation will become self-perpetuating, causing long-lasting damage to the French economy. An increase in investment would bolster demand. However, compared to its main partners France has managed to maintain the level of both public and private investments throughout the crisis. The issue is therefore mostly about improving investment to increase the country's potential output growth. There are two conceivable possibilities – that are not mutually exclusive and would likely be mutually reinforcing – to foster investment in the short run: France can act alone or it can spearhead a wider European-level public investment plan. Given France's high level of public debt and its commitments under the Stability and Growth Pact, the first option would be achieved by changing the composition of public spending, improving the quality of investments and public guarantee mechanisms or strengthening the ongoing Future Investment Programme (PIA). A more ambitious European-wide investment package would be based on an additional budget within the framework of a new investment initiative or a dedicated European borrowing facility.

Eight years after the end of the global financial crisis, the French economy continues to grow at a noticeably slower pace than the 2.3% average annual growth it recorded from 1995 to 2007. Today, many economists and international organizations fear hysteresis effects due to long-term unemployment and decreasing labour force participation and the decline of the stock of capital resulting from insufficient investment. This predicament, which isn't specific to France, could become self-perpetuating and cause long-lasting damage to potential growth. This perspective is all the more worrying as it is compounded by weak productivity gains and lacklustre potential growth observed throughout advanced economies.[1] According to European Commission estimates, French potential growth fell from a pre-crisis average of near 2.0% to 0.9% more recently.

PRODUCTIVITY GROWTH — GDP GROWTH



SOURCE: AMECO, European Commission.

1. See Jaubertie A. and Shimi L. (2016), "Où en est le débat sur la stagnation séculaire ?", *Trésor-Éco* n°182.

In reality this slowdown predates the economic crisis and concerns most advanced economies. It results first and foremost from supply-side problems, which limit the capability of French companies to take advantage of growth opportunities in world markets. Despite some improvement thanks to its Employment-Competitiveness Tax Credit (CICE, *Crédit d'Impôt Compétitivité-Emploi*), France's cost-competitiveness has deteriorated, and its product quality range is suboptimal. What's more, the country has lost international market share.[2] In the years since the crisis weak domestic demand has added to these supply-side factors. This is reflected in the fact that GDP remains below its potential level[3] and in the persistence of high cyclical unemployment.

Increased public investment would help to counter the supply-side problems hindering growth and buoy demand. The OECD and the IMF have recently called for such action,[4] warning against the risks of sustained economic stagnation. Furthermore, central bank easing has enabled many countries to borrow at extremely low rates.

Despite falling by almost 10% since 2008, at 3.4% of GDP public investment[5] in France, remains considerably higher than in Germany (2.2%), the UK (2.6%) and the EU (2.7%). Compared with other advanced economies, France is already equipped with relatively higher-quality infrastructure.[6] Given these initial starting conditions, the risk is that an increase in public investment would finance projects with low socio-economic returns.

For this reason, the challenge facing France is, first and foremost, that of selecting public investment projects that are likely to crowd-in private investment and improve productivity and potential growth in the long run without operating costs increasing future deficits. This calls for investing in the needs of the future, such as the energy transition (e.g. thermal insulation of buildings, clean urban transportation and electrical vehicle infrastructure), digital infrastructure, venture capital financing, higher education and research. Current expenditure items like funding for innovation, healthcare and education do not meet the national accounts definition for investment, yet they should be included because they are also likely to increase potential growth.

There is no reason for these investments to be financed by the public sector alone, but the public sector can act as a catalyst where market return is too low or the level of risk too high for the private sector to finance these investments projects without public support. For example, in the case of the energy transition, the public sector has a key role to place given that the current environment of low oil prices and low carbon prices does not incentivize private investment in clean energy.

Faced with the need to support potential growth and prepare for the future, France must choose a direction for its broader investment strategy. The economic consensus on the use of fiscal policy in the context of stagnant economic activity is evolving in this regard.[7]

There are two possibilities for improving investment in the short term: (i) act alone and use the flexibility allowed in the current European framework; or (ii) spearhead a more ambitious investment plan at the European level alongside other EU member states.

2. For a full assessment, see Sode A. (2016), "*Compétitivité : que reste-t-il à faire ?*", Enjeux 2017-2027, France Stratégie.

3. The output gap was about -1.4 percentage point in 2016 according to a European Commission estimate.

4. OECD (2016), "Using the Fiscal Levers to Escape the Low-Growth Trap", Chapter 2, *OECD Economic Outlook*, Issue 2; IMF (2016), *World Economic Outlook*, October: "Subdued Demand, Symptoms and Remedies".

5. In the sense of the national accounting defintion, in other words gross fixed capital formation (the value of net aquisitions of new or existing tangible and intangible [e.g. patents] produced assets that are used repeatedly or continuously in other production processes, not taking into account the depreciation of capital).

6. See Cour des Comptes (2015), "*La situation et les perspectives des finances publiques*" ; Douillard P., Janin L. and Lorach N. (2014), "*Y a-t-il un retard d'investissement en France et en Europe depuis 2007 ?*", La Note d'analyse n°16, France Stratégie.

7. See Furman J. (2016), "The New View of Fiscal Policy and Its Applications," mimeo.

OPTION 1

A NATIONAL STRATEGY FOR IMPROVING AND STIMULATING INVESTMENT

The current weakness in interest rates raises a legitimate debate about how best to seize this opportunity, given that investment needs can be financed at a lower cost today than in the future.

There are two possible scenarios: a permanent increase in public investment or a temporary increase, for example, over three years. Under conservative assumptions regarding the size of fiscal multipliers and assuming a gradual rise in interest rates, an additional €10 billion in annual public investment would increase France's debt-to-GDP ratio by around 0.5 to 1.5 percentage points by 2027. Moreover, the investment could be self-financing if over the long term it leads to a sustained increase in potential growth and generates savings through the modernization of government bureaucracy. It could also reduce future social transfers, for example, by increasing labour force participation. The OECD finds[8] that under certain conditions France could increase its investments over four years without impacting the public debt-to-GDP ratio by 2040. Additional investment would also have a neutral impact on the debt level if it were offset by less investment in the future.

It is unlikely that a boost in public investment would lead to adverse market reactions and thereby increase interest rates on French debt as long as France's commitment to sound budgetary policies is not called into question. The move should therefore be accompanied by a credible path for continued budgetary adjustment and a thorough, transparent process for the selection and implementation of the public investments.

Given its high level of public debt and its commitments under the Stability and Growth Pact, France has three other options available if it chooses to act alone: (i) reorganize public spending to promote investment; (ii) boost deficit-neutral investments under the PIA; and (iii) use public guarantee mechanisms that do not increase public spending in the short term.

8. OCDE (2016), *op. cit*.

REDIRECTING PUBLIC SPENDING TOWARDS INVESTMENT AND IMPROVING ITS QUALITY

The quality of public spending could be improved by gearing its composition towards expenditure items with the highest impact on potential growth. The short-term impact would be quite low, however, as this option would involve reallocating public spending between categories without increasing its overall amount.

Sticking to the adjustment path for public finances already requires substantial cuts to public spending. Reallocating public spending in favour of public investment or other growth-enhancing expenditure items would require identifying additional sources of savings. In this paper, we do not answer the question of what types of spending should be reduced but instead focus on which expenditure items could be increased.

In order to avoid future increases in the deficit related to operating expenditures, priority should be given to investing in the renovation and maintenance of existing infrastructure as it typically generates less additional operating costs than new infrastructure. Other types of spending that boost potential growth, such as research or education, are also justified. Closing the gap with the best performers in education, for example, would require up to 1.4 percentage points of GDP in additional spending.[9]

France also has considerable room to improve the quality of public investment. The 2012 multi-year public finance programming act (*Loi de Programmation des Finances Publiques*) requires investment projects financed by the state and public institutions to be subject to prior socio-economic assessment, with independent counter-expertise coordinated by the government's General Commission for Investment (*Comissariat general à l'investissment*, CGI). These assessments could still be improved and are insufficiently taken into account in the decision-making process.[10] France still lacks a full inventory of investment projects, and the impact assessments are often quite basic, with no standard methodology between and within investment categories. On all of these points, the solution lies in drawing up a sufficiently detailed and robust methodology for assessing the costs and benefits of different types of investment.[11]

More fundamentally, two-thirds of public investment is carried out by local and regional governments that are not subject to the provisions and requirements of the 2012 public finance programming act as far as socio-economic assessments are concerned. The central government should work more closely with local and regional governments, possibly within a joint network, with a view to improving evaluation practices and thereby the quality and usefulness of investment projects.

As an alternative to infrastructure investment, France could focus on projects that would ultimately reduce public sector operating costs, such as investments that contribute to modernizing and digitizing public services.[12] The 2014 territorial reform is, for example, expected to lead to considerable savings in the medium term but might initially require some additional spending to ensure that the necessary conditions are in place. The expected reduction in public expenditure from these investments can be quite high, but they often entail large upfront costs.[13]

INCREASING DEFICIT-NEUTRAL PIA INVESTMENTS

In 2010, France launched its innovative PIA, which is currently entering its third phase. The programme is headed by the CGI and aims to encourage innovation by promoting research and higher education, with the ultimate objective of improving the competitiveness of the French economy in the long term. A total of €47 billion were dedicated to the first two phases of the programme, and an extra €10 billion have been pledged for the third phase, which has just begun. According to the programme's mid-term review committee, the PIA has had positive effects both from a quantitative and a qualitative point of view.[14] Some of the projects are supported by financial endowments (the principal is unavailable for use), which have very little impact on the public deficit in the Maastricht sense, and equity participations and loans, which have no impact. In the third phase of the programme, €6 billion have been earmarked in this category. France could continue along this path to increase investment in the coming years without running afoul of its Stability and Growth Pact requirements. This would, however, considerably narrow the range of projects that can be financed.

EXTENDING PUBLIC GUARANTEES

France could explore more innovative ways to support investment. One possibility could be to provide public guarantees to lower the risk of certain long-term investment projects, thereby crowding-in private sector financing. For example, the state could guarantee a path for the future price of carbon, helping to unlock low-carbon investments by reducing uncertainty as to the price of carbon emissions in the future. This type of support – in the form of a commitment to compensate for deviations from expected outcomes – would help reduce risk for project initiators and lower financing costs. It could possibly be used for other types of investment.[15] However, a robust selection process for eligible projects would be needed to avoid expenditure overruns in the future.

9. Agacinski D., Harfi M. and Ly S. (2017), "*Quelles priorités éducatives ?*", Enjeux 2017-2027, France Stratégie.

10. Cour des Comptes (2015), *op. cit.*; *Évaluation des grands projets d'investissement public*, report prepared for the 2015 budget.

11. Launched as a joint initiative by France Stratégie and the CGI, the Expert Committee on Socio-Economic Evaluation, whose inaugural meeting was held in January 2017, will be tasked with helping to define standardized methodologies for socio-economic evaluation and generalize their use both at the central government and sub-national levels.

12. Ragot X., Thimann C. and Valla N. (2016), "*Taux d'intérêt très bas : symptôme et opportunité*", *Les Notes du Conseil d'analyse économique*, n°36, December.

13. As an example, the cost of Chorus software for managing the state's accounts is estimated at nearly €1 billion but is expected to generate annual savings of near €400 million. See *Rapport Annuel de Performance 2014, Gestion des finances publiques et des ressources humaines*.

14. France Stratégie (2016), *Programme d'investissements d'avenir. Rapport du comité d'examen à mi-parcours*, 29 March.

15. For a typology, see OECD (2016), *Progress Report On Approaches To Mobilising Institutionnal Investment For Green Infrastructures*, September.

OPTION 2

A MORE AMBITIOUS INVESTMENT PLAN FOR EUROPE

France could attempt to rally other EU member states and spearhead a more ambitious investment strategy for Europe. Two potentially complementary solutions could be considered: (i) commit additional budget resources at the European level to be used in the context of a new investment plan; (ii) create a new fund at the European level on the basis of a common borrowing capacity.

A NEW EUROPEAN INVESTMENT PLAN WITH ADDITIONAL BUDGET RESOURCES

The Junker plan is backed by a €16 billion guarantee from the European Commission under the EU budget and a €5 billion contribution from the European Investment Bank (EIB). A total of €315 billion euros worth of private investments are expected to be crowded-in over three years at the European level (from mid-2015 to mid-2018). The plan is on track so far: at the halfway mark nearly €165 billion euros worth of projects have been launched of which more than €21 billion for projects in France. The European Council decided in December 2016 to extend the plan to 2020 and bring it to €500 billion thanks to additional contributions from the EU budget and the EIB.

France could seek to persuade other member states to go even further by committing additional budget resources and excluding these contributions from the examination of compliance with Stability and Growth Pact requirements. This new investment plan would seek to finance riskier projects, possibly including a more systematic subsidy component for certain types of projects. Only projects with large socio-economic returns would be considered on the basis of a thorough selection process at the European level on the same model as what France has set up under its PIA. With a relatively low subsidy rate of around 10% – calculated on the basis of the project's collective value to supplement its market value – the leverage effect could potentially be much greater than that of the current investment plan.

A NEW EUROPEAN BORROWING FACILITY

Member states could backstop a fund that would borrow from markets to finance investments that are not undertaken by the private sector in order to increase potential growth in the EU.

This new borrowing facility could, for example, be tasked with funding a large-scale EU-wide training programme, which would focus on skills shortages and professions with high job-vacancy rates. The fund could serve as a guarantee to a system of contingent loans set up for this purpose. Beneficiaries would only repay loans when their income exceeds a certain pre-determined threshold. The guarantee fund could also help to accelerate the energy transition by setting up a guarantee mechanism for the price of carbon along the lines set out above – only at the EU level. Such a fund could be housed within the EIB or set up as an ad hoc vehicle financed by only some member states. With no impact on member states' public finances, such a fund could provide an important boost to investment in Europe.

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France Stratégie launched its "2017/2027" project to both foster and inform debate among citizens ahead of the 2017 presidential elections. It aims to zero in on what is likely to shape policy over the next decade and examine the different choices facing the country and the divergent paths it may take.
It has published on a dedicated website a series of papers on key issues since March 2016. Experts and civil society representatives have also made contributions. None of the documents published reflect the government's official positions.