The rules of the game regarding the fiscal framework have changed in the euro area. Write a briefing to Ursula von der Leyen, President of the European Commission, on the appropriate fiscal policy stance for France and Portugal in the next few years.

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"Blessed are the young, for they shall inherit the national debt." – Herbert Hoover, 31st President of the USA (1929–1933), during the Great Depression.

This quote highlights the enduring challenge of intergenerational debt—a problem that remains just as pressing today. Nearly a century later, on the other side of the Atlantic, the euro area grapples with renewed fiscal challenges amidst shifting economic landscapes.

Advising the fiscal policy stance for France and Portugal in the coming years is undoubtedly complex. Both nations must pursue more sustainable debt trajectories, particularly as they mark two decades of exceeding the Stability and Growth Pact's 60% debt-to-GDP threshold. However, their distinct economic contexts necessitate tailored approaches.

The European Commission plays a vital role in offering clear and customized guidance to France and Portugal, helping them align their strategies with shared goals of European strength, stability, and unity.

We will first outline the shared principles of an efficient fiscal policy. Then, we will examine France's personalized recommendations, followed by an analysis of Portugal's.

General Framework

As you know, the Stability and Growth Pact (SGP), designed to ensure that countries in the European Union pursue sound public finances and coordinate their fiscal policies, was reformed recently after being suspended during the COVID-19 crisis, when fiscal stimulus and exceptional measures were necessary. This reform retains the most notable parts of the SGP: maintaining a deficit below 3% of GDP and debt under 60% of GDP. It also aims to clarify the rules and provide a more realistic path to sustainability. For example, a country with a high debt-to-GDP ratio might be required to reduce its debt by around 1.5% to 2% of GDP per year, depending on its economic growth, interest rates, and structural reforms, rather than adhering to a flat 5% reduction.

However, the reform introduces more realistic objectives regarding the current context and supports key areas of growth-oriented investment, such as the green sector and digital transformation.

The modern way of analyzing and supporting policy stances in an indebted country is to focus less on the absolute level of debt and more on the purpose for which the debt is contracted.

A policy stance requiring debt reduction can be effective if implemented with the right objectives and strategies, particularly by focusing on long-term productive investments such as education, which enhance economic growth and fiscal sustainability over time.

If the debt is contracted to sustain inefficient systems where institutions are underproductive and government expenses are poorly oriented, then the European Commission needs to intervene to warn the country that such debt contraction isn't sustainable. A deep analysis of the Finance Bill permits distinguishing between government expenses that lead to long-term growth and stability and those that are ineffective.

Furthermore, a successful fiscal policy uses automatic stabilizers, which are a critical foundation for offering immediate, counter-cyclical support. When combined with well-targeted discretionary measures, they create a robust framework for economic stability and recovery. They introduce an element of endogeneity between fiscal policy and the real economy, ensuring an instant repercussion of cyclical events while avoiding the time lag inherent in discretionary policies.

After examining the key tools for a fiscal policy stance in general, we now address the unique measures each country should implement, as advised by the European Commission.

France

France is going through a political crisis, primarily due to the deficit increase and questions about its debt sustainability. As the second-largest economy in Europe, France's challenges have significant implications for the euro area as a whole. If France falters economically, it affects the stability of Europe at large.

France is currently under the Excessive Deficit Procedure (EDP). The 2024 budget deficit was underestimated, initially projected at 4.1%, but it now exceeds 5.5% and may even reach 6%. This was obscured by the previous government, and the projected deficit for 2025 could reach 6.2% if the budget remains unchanged. Brussels has placed France under "excessive deficit" monitoring to push it to cut deficits over a five-year period. By 2025, the deficit must fall below 5% of GDP, requiring a €60 billion budget cut, and it must drop below 3% by 2029.

Three major obstacles hinder France's progress:

Tax Cuts and Fiscal Credibility Macron's policy of lowering taxes for companies is at least partially responsible for the deterioration of France's deficit. Between 2018 and 2023, the period was marked by significant tax cuts, with an estimated impact of €62 billion in 2023 (2.2 GDP points). La Cour des comptes (France's supreme audit institution) warned of this issue at the beginning of 2024. Additionally, the previous government, especially Bruno Le Maire, has been accused of obscuring these problems in recent years. He is currently under investigation by a parliamentary inquiry commission on public finances. This has undermined the government's credibility, making it seem incapable of managing its own deficit or accurately forecasting its value.

Low GDP Growth Since 2020, France's GDP has grown by less than 1% annually. If France achieved GDP growth above 2%, as in Portugal, it would improve its debt-to-GDP ratio and increase fiscal flexibility. Unfortunately, low growth limits tax revenue generation, and the deficit situation will definitively not improve on its own.

Geopolitical Costs and Military Spending The war in Ukraine has underscored the need for military strength to maintain deterrence and address geopolitical threats. France's substantial financial support to Ukraine—up to €3 billion as promised by Macron in February 2024—adds further strain to its fiscal capacity.

We do not advocate for disproportionate austerity measures that would worsen France's low-growth situation. Instead, agility lies in distinguishing between expenditures and preserving those with a positive impact on GDP growth, such as investments in green energy, digital transformation, and infrastructure. Balancing the need for tax revenues with measures that do not stifle economic activity is essential.

Portugal

The context in Portugal is very different. Portugal has a high public debt (around 110% of GDP in 2023), but the country has made significant efforts to reduce its deficit and stabilize its debt in the years following the 2011 financial crisis and the COVID-19 crisis. Portugal is not under the Excessive Deficit Procedure (EDP).

Although Portugal has demonstrated better debt dynamics recently, it faces other major concerns for its policy stance while maintaining its surplus and reducing its debt to a 60% debt-to-GDP ratio:

Immigration and Demographics To offset its negative natural population balance, which will worsen with an aging population, Portugal must maintain and incentivize immigration. Policies should attract young, skilled workers to benefit economic growth and address the brain drain of Portuguese talent emigrating to other countries. At the same time, Portugal must continue investing in education and workforce training to enhance productivity and address structural unemployment, ensuring its labor market meets modern demands.

Green Transition Portugal must strengthen investments in renewable energy and sustainable infrastructure, which represent significant growth opportunities given the country's climate and EU climate goals.

Digital Transformation Investments in technology infrastructure and start-ups are essential for driving innovation and boosting long-term economic growth.

By prioritizing strategic investments, addressing structural challenges, and leveraging EU support, Portugal can strengthen its economy and contribute to the broader stability and unity of the European Union.

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