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Fiscal reform and fiscal sustainability: Evidence from Australia and Sweden

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ABSTRACT

This paper examines how the adoption of a fiscal rule affects the sustainability of fiscal policy in two OECD countries; Australia and Sweden. In Australia, we show that government revenues are not necessarily growing at a faster rate than government expenditures, at least from the viewpoint of a statistical long-run relationship. In contrast, in Sweden, we show that the reform is more beneficial for the attainment of a budget surplus.

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1. Introduction

In the 1990s, many OECD countries undertook various approaches to fiscal reform. Three types of reforms were typically undertaken: (i) the introduction of numerical fiscal rules; (ii) the reform of budget procedures; and (iii) the introduction of independent fiscal institutions.

Of these three approaches, the introduction of numerical fiscal rules has been necessary and effective for consolidating government budgets. In terms of the outcomes of these approaches in the European Union (EU), Hallerberg, Strauch, and von Hagen (2007) argued that the severity of fiscal rules appeared to restrain public debt regardless of the ideological distance between the ruling parties. Moreover, as Franco and Zotteri (2010) argued, even some countries where strong powers were assigned to the finance minister or prime minister introduced expenditure rules in the 1990s. There is also the expectation that independent fiscal institutions provide policy advice through forecasts and fiscal analysis. However, as argued by Fatás (2010), independent fiscal institutions may be the appropriate authorities to complement numerical rules.

Incidentally, to meet balanced budget targets, governments may often prefer spending cuts to tax increases because of the relatively small macroeconomic trade-off. Furthermore, for the purpose of fiscal adjustment, Konishi (2006) and Alesina (2010) showed that governments tend to focus on expenditure restraint rather than on increasing taxes. Following this, we focus on the effect of budget expenditure rules (or ceilings). In this context, we define the introduction of an expenditure rule as a type of "fiscal reform".

Many countries introduced budget expenditure rules in the 1990s. For example, since 1996, Sweden has been implementing ceilings that set expenditure limits over a three-year period. Under the Swedish rule, expenditures are not allowed to increase

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over a three-year period. Australia has been setting limits on annual expenditures since 1996. The ceilings are legally enforced by the Charter of Budget Honesty Act, established in 1998. The Australian rule is linked to forward estimates of future economic growth and expected budget balances. However, although the level of expenditure is flexible, the rule functions as a limit on expenditures in certain years.[1] Australia and Sweden introduced fiscal rules following fiscal aggravation in the early and mid-1990s owing to the economic slowdown. With regard to other countries, as a condition for forming a coalition government in the Netherlands in 1994, the coalition parties also agreed on expenditure rules. Although Japan committed to decrease government expenditures through the Fiscal Structural Reform Act in 1997, the act was suspended in December 1998.[2]

Until the mid-1990s, both Australia and Sweden were typically categorized as countries without expenditure ceilings, and as countries in which there was little evidence that the prime minister or finance minister dominated budget negotiations, as shown by von Hagen and Harden (1995), De Haan, Moessen, and Volkerink (1999), and Perotti and Kontopoulos (2002). By contrast, the Netherlands was seen as a country that did implement expenditure ceilings and in which the prime minister or finance minister dominated budget negotiations.[3] Thus, the recent fiscal reforms undertaken in these countries are evidence of the reinforcement of "existing" fiscal rules and of the reinforcement of the power of the fiscal authorities. Moreover, unlike the Japanese Fiscal Structural Reform Act, the reforms undertaken in both Australia and Sweden remain effective.

When compared with the reforms conducted in countries with only primitive expenditure ceilings or strong fiscal authorities, and compared with the Japanese experience, the reforms conducted in Australia and Sweden clearly altered their "fragile" public finance systems and should essentially be considered examples of the "permanent" introduction of fiscal rules.[4]

The Australian and Swedish reforms may contribute to fiscal policy sustainability when the government budget deficit has not been on a hitherto sustainable path. The mechanisms are as follows. First, the government may attempt to restrict spending based on the ceiling. Second, the rules may lead to a reduction in the government's deficit. Third, the government may achieve fiscal soundness through deficit reduction and, consequently, maintain the sustainability of fiscal policy.

Conversely, countries that do not adopt or apply the rules may not contribute to fiscal policy sustainability. For example, as mentioned earlier, the Japanese government abolished the Fiscal Structural Reform Act in 1998. The Japanese government has not since adopted a legal rule to consolidate the government budget. This may explain the continuous increase in the Japanese government's debt, and some existing researches show that fiscal policy in Japan may not be sustainable.[5] The fact that reforms in Australia and Sweden have been effective suggests that they, unlike Japan's reforms, may contribute to fiscal policy sustainability.

Some recent studies, such as those of Fatás (2010), Franco and Zotteri (2010), and Rose (2010), have identified a relationship between fiscal rules and the sustainability of fiscal policy. Franco and Zotteri (2010), in particular, discussed the relationship between fiscal reform and fiscal sustainability and emphasized that fiscal rules play an important role in ensuring the sustainability of fiscal policy, as we assume. However, these researchers did not examine the issue by using econometric techniques. On the other hand, there exist many previous studies that consider the sustainability of fiscal policy in general, including those of Hakkio and Rush (1991), Trehan and Walsh (1991), Ahmed and Rogers (1995), Quintos (1995), Bohn (1998), Martin (2000), Bravo and Silvestre (2002), Afonso (2006), Uctum, Thurston, and Uctum (2006), Bohn (2007), Bohn (2008), Afonso and Rault (2009), and Legrenzi and Milas (forthcoming).[6] Olekalns (2000), Hatemi-J (2002a), and Hatemi-J (2002b) examined sustainability in the Australian and Swedish cases. However, to our knowledge, no empirical work has been undertaken on the sustainability of fiscal policy that incorporates fiscal reform.[7]

Hence, our objective is to analyze how the adoption of a "permanent" fiscal rule affects the sustainability of fiscal policy in Australia and Sweden. We focus on a numerical fiscal target and, in particular, we define the introduction of expenditure rules as a fiscal reform, which is assumed to be a structural change. This is why such an introduction changes the intertemporal relationship between revenues and expenditures and puts fiscal policy on a sustainable path.

The process is as follows. First, we test for cointegration between government revenues and expenditures. Second, we estimate the cointegration vector in order to determine whether the introduction of a fiscal rule would contribute to making the government's budget sustainable. Third, to examine the influence of fiscal reform, we use the dynamic ordinary least squares (DOLS) approach developed by Stock and Watson (1993) to estimate the coefficient of the fiscal variable that exhibits a structural break.

[1] For details of the reforms conducted in Australia and Sweden, see Kennedy and Robbins (2003), Simes (2003), and Wehner (2007).

[2] For an appraisal of Japanese fiscal institutions and fiscal reform, see Tanaka (2003) and von Hagen (2006).

[3] von Hagen and Harden (1995) argued that the budget process in the Netherlands was governed by a firm commitment to the setting of a numerical target, even before the 1990s. On the basis of this and the agreements subsequently introduced in 1994, Perotti and Kontopoulos (2002) characterized the Netherlands as having expenditure ceilings from 1970 to 1995. The budget process in the UK relies heavily on the authority of the Treasury. Hallerberg et al. (2007) pointed out that the degree of commitment improved in Denmark between 1991 and 2004. However, Denmark can be classified as a country with primitive fiscal rules, at least according to surveys conducted from the 1980s to the mid-1990s.

[4] New Zealand also introduced a fiscal rule in the form of the Fiscal Responsibility Act in 1994. However, to our knowledge, unlike in the cases of Australia and Sweden, there has been no examination of the effect of fiscal rules or of the strength of the fiscal authorities in New Zealand's public financial system before the introduction of the Act. Therefore, we cannot investigate this case with confidence because it may be difficult to judge evenhandedly whether New Zealand's fiscal reform represents evidence of the introduction of "brand-new" fiscal rules or simply of the reinforcement of existing rules and procedures.

[5] For example, by using a dynamic stochastic general equilibrium model, Hosono and Sakuragawa (2010) and Hosono and Sakuragawa (2011) found that the debt–GDP ratio has gradually increased, thereby causing Japanese government debt to become unsustainable. A recent paper by Doi, Hoshi, and Okimoto (2011) demonstrated the unsustainability of Japanese fiscal policy by estimating a fiscal policy function with Markov switching.

[6] For similar researches, a recent paper by Afonso and Jalles (2013) examines the effects of government debt on the economic growth and productivity using a panel of 155 countries. Further, Xie and Chen (2014) examine the causal relationship between government budget and current account deficits in OECD countries.

[7] Hatemi-J (2002b) examined the sustainability of Swedish fiscal policy incorporating structural breaks to confirm that it satisfied EMU criteria. However, Hatemi-J (2002b) did not examine the effects of the introduction in 1996 of the rules considered in this paper.

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