

Har finanspolitik omvända effekter under omfattande
budgetsaneringar? Den svenska budgetsaneringen 1994-97,
Rapport till Finanspolitiska rådet 2010/2

Expansionary Fiscal Contractions: Re-evaluating the Danish
Case, *International Economic Journal*, vol. 24, pp. 71–93, 2010
(with Michael Hutchison)

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Focus of these papers

- Key research question: Has fiscal policy reversed effects during major fiscal consolidations? Two cases: The Swedish budget consolidation 1994–97 and the 1983 Danish fiscal reform.
- Study the effects of fiscal policy on output, private consumption and unemployment and distinguish between normal and non-normal times (during major budget consolidations).
- Also condition on external influences by including a measure of world business cycles.

Why study budget consolidations?

- There is a need for major budget consolidations throughout Europe which could have consequences for the economy during its recovery.
- Fear among politicians (and economists) that restrictive fiscal policy will lead to lower output and private consumption and higher unemployment.

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- There is a need for major budget consolidations throughout Europe which could have consequences for the economy during its recovery.
- Fear among politicians (and economists) that restrictive fiscal policy will lead to lower output and private consumption and higher unemployment.
- A major fiscal contraction which leads to the expectation of permanently lower future paths of government consumption and taxation could in some circumstances be expansionary (termed the “expansionary fiscal contraction hypothesis” (EFC) (Blanchard (1987), Giavazzi and Pagano (1990), Bertola and Drazen (1993), Sutherland (1997), Barry (1999), Perotti (1999), Giavazzi, Jappell and Pagano (2000)).

Earlier empirical evidence

- Results consistent with EFC hypothesis: Alesina and Perotti (1995) Perotti (1999), Giavazzi, Jappelli and Pagano (2000), Höppner and Wesche (2000), Afonso (2006), and Bergman and Hutchison (1999).
- Results inconsistent with EFC hypothesis: van Aarle and Garretsen (2003), Hjelm (2002), Andersen and Risager (1990,1991) and Andersen (1994)

Why study the Swedish budget consolidation?

- The large Swedish fiscal contraction that was implemented after the financial crisis in 1994 is an interesting case study.
- It was substantial and broad reaching in that it covered both public sector spending as well as taxes and other reforms.
- The primary budget deficit as a percentage of GDP improved from a large deficit (-7.9 percent) in 1994:3 to surplus (2.1 percent) in 1998:1. Economic growth increased significantly (from -0.5 to 4.2 percent).
- Public expenditures declined from 68.2 percent of GDP to 58.1 whereas total revenue increased from 59.4 to 61.8 percent of GDP.

Why study the 1983 Danish fiscal reform?

- It was substantial and broad reaching in that it covered both public sector spending, public sector wages, taxes and other reforms.
- The cyclically adjusted deficit improved by 9.5 percent of GDP over the three-year consolidation period. Real GDP and consumption growth averaged 3.7 and 4 percent, respectively. Unemployment declined by 2.2 percentage points during the period.
- Implemented in stages between 1983 and 1986 and considered as one of the most successful budget consolidation experienced in the OECD area,
- The economy's strong performance was unexpected, it was anticipated that the fiscal contraction measures would have a significant adverse short run effect in line with Keynesian predictions.

Empirical strategy

- “Event study” approach using standard structural vector autoregression model (VAR) (Blanchard and Perotti (2002)).
- Model is comprised of four or five variables (GDP, private consumption, public consumption, direct taxes and unemployment). G-7 output gap is included as an exogenous variable. Budget consolidation is modelled using a dummy variable.

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- Main results:
 - Fiscal policy has the standard Keynesian effects during normal times; a fall (rise) in government consumption expenditures (taxes) reduce consumption and output and increase unemployment.
 - No significant EFC effects during the Swedish budget consolidation but strong significant effects during the Danish fiscal reform.

Figure 1: Impuls response of GDP (Y), private consumption (C) and unemployment (U) to increased taxes (T) and to a fall in public consumption (G) during “normal” times, the Swedish case.

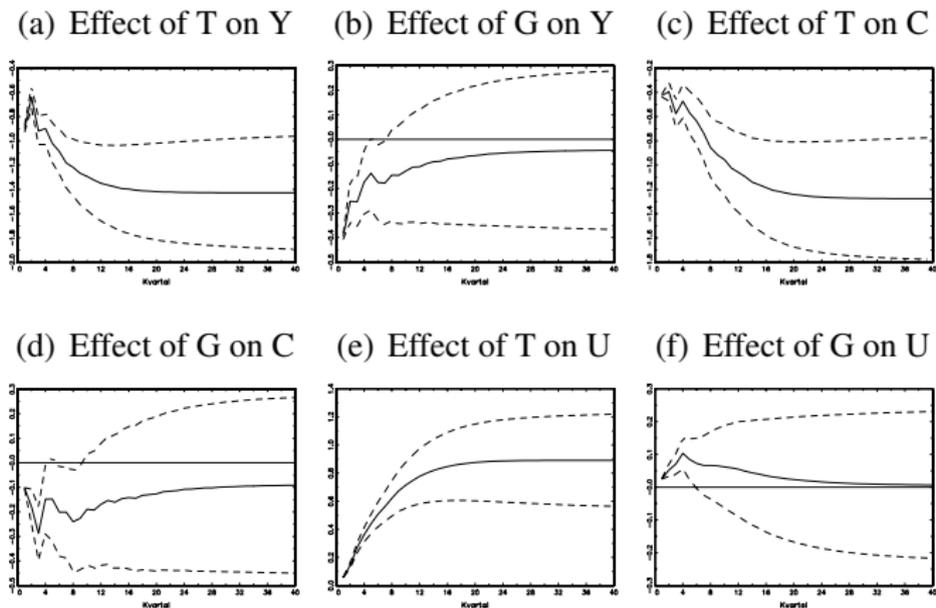


Figure 2: Impulsresponse of GDP (Y) and private consumption (C) to increased taxes (T) and public consumption (G) during “normal” times, the Danish case.

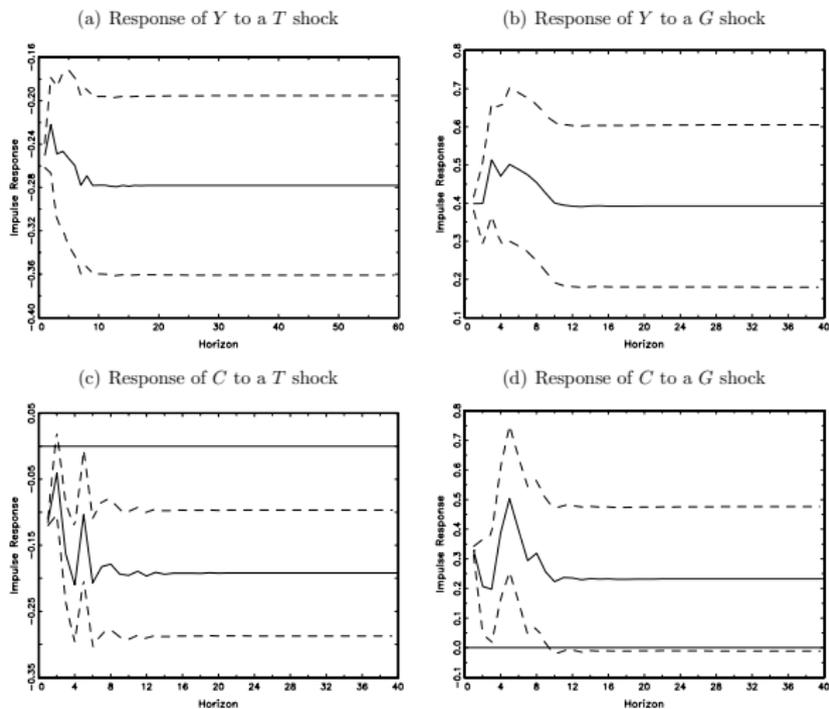


Figure 3: Impulse response of (Y), private consumption (C) and unemployment (U) to the Swedish budget consolidation.

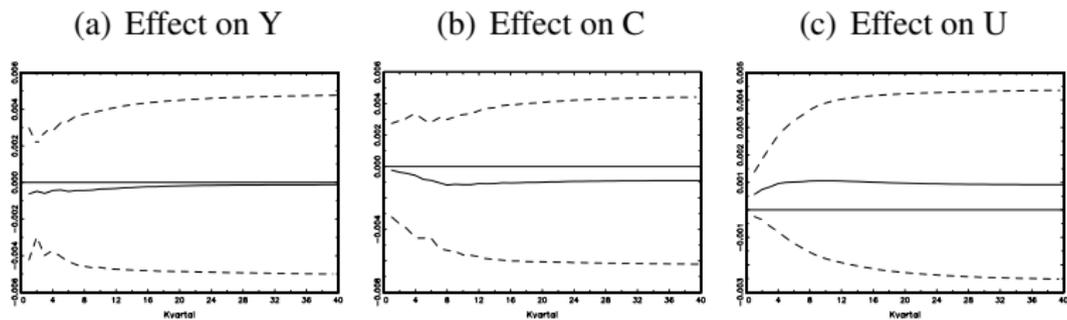


Figure 4: Impulse response of (Y) and private consumption (C) to the Danish fiscal reform.

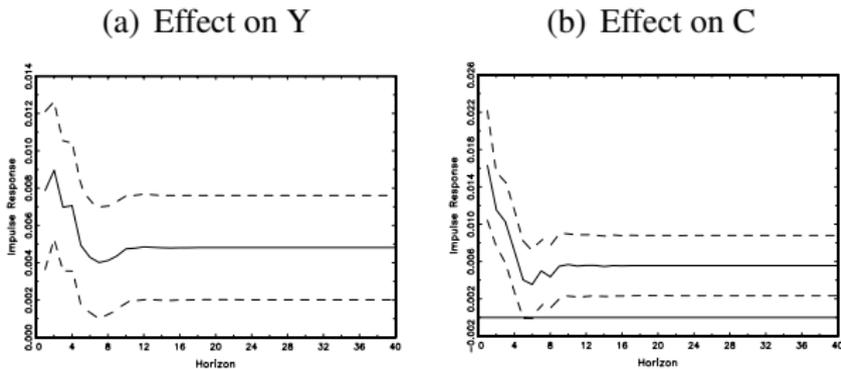


Figure 5: Historical decomposition of GDP and private consumption during and after the Swedish budget consolidation 1994–97.

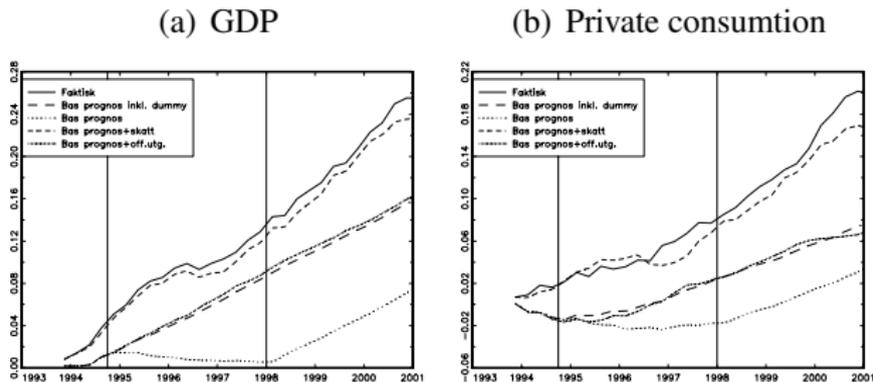
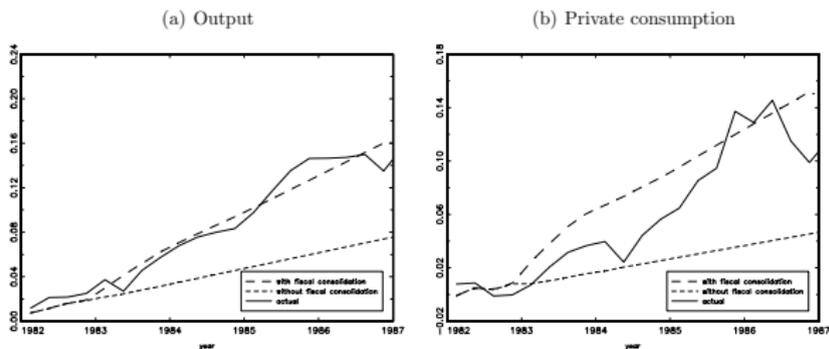


Figure 6: Historical decomposition of GDP and private consumption during and after the Danish fiscal reform 1983.



Conclusions

- Standard Keynesian effects of fiscal policy during normal times (both in Denmark and in Sweden). Consistent with most other empirical studies.
- No significant of the Swedish fiscal consolidation but significant effects of the Danish fiscal reform.

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- Standard Keynesian effects of fiscal policy during normal times (both in Denmark and in Sweden). Consistent with most other empirical studies.
- No significant effects of the Swedish fiscal consolidation but significant effects of the Danish fiscal reform.
- Possible explanations of why the EFC hypothesis is rejected for Sweden but not for Denmark:
 - Sweden: Households did not revise their expectations about future taxes, they expected all tax changes to be permanent not temporary (one example is the extra tax on high income "värns-katten" which was said to be temporary but became permanent). Households expected no permanent change in government expenditures.
 - Denmark: Households did revise their expectations about future expenditures. Reforms more focused on public sector spending. More substantial than the Swedish contraction.

Thank you!