

GAO

Report to the Chairman and Ranking
Minority Member, Committee on the
Budget, U.S. Senate

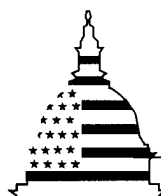
November 1999

BUDGET SURPLUSES

Experiences of Other Nations and Implications for the United States



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Abbreviations

AME	annually-managed expenditure
CAP	Canada Assistance Plan
CHST	Canada Health and Social Transfer
CPP	Canada Pension Plan
DEL	departmental expenditure limits
EI	Employment Insurance
EPF	Established Programs Financing
EU	European Union
FRA	Fiscal Responsibility Act
GDP	gross domestic product
GIS	Guaranteed Income Supplement
GST	goods and services tax
MMP	mixed member proportional
NAO	National Audit Office
OAG	Office of the Auditor General
OAS	Old Age Security
OECD	Organization for Economic Cooperation and Development
PAYGO	pay-as-you-go
PSBR	public sector borrowing requirement
PSNB	public sector net borrowing
PSNCR	public sector net cash requirement
RAB	resource accounting and budgeting
TFF	Territorial Formula Financing
U.K.	United Kingdom
VAT	value added tax



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Comptroller General
of the United States

United States General Accounting Office
Washington, D.C. 20548

B-281269

November 2, 1999

The Honorable Pete V. Domenici
Chairman
The Honorable Frank R. Lautenberg
Ranking Minority Member
Committee on the Budget
United States Senate

As you requested, this report reviews the experience of six nations with budget surpluses—Australia, Canada, New Zealand, Norway, Sweden, and the United Kingdom. You asked us to determine how these nations achieved budget surpluses, used surpluses to address long-term budgetary pressures, and adapted their budget processes once surpluses were achieved.

Like the United States, these nations achieved budget surpluses largely as the result of improving economies and sustained deficit reduction efforts. As they entered a period of surplus, these nations debated how surpluses should be used and developed unique strategies for using surpluses to address national priorities. The experiences of these nations suggest that it is possible to sustain support for continued fiscal discipline during a period of surpluses while also addressing selected pent-up demands.

We are sending copies of this report to the Honorable John R. Kasich, Chairman, and the Honorable John M. Spratt, Jr., Ranking Minority Member, House Budget Committee and other interested parties. We will make copies available to others upon request.

This report was prepared under the direction of Paul L. Posner, Director, Budget Issues, who may be reached at (202) 512-9573 if there are any questions.

David M. Walker
Comptroller General
of the United States

Executive Summary

Purpose

In fiscal year 1998, the United States achieved a unified budget surplus for the first time in nearly 30 years. Budget surpluses represent both the success of past deficit reduction efforts and an opportunity to address pressing needs. With the arrival of surpluses there has been much debate about whether surpluses should be maintained and how they should be used. While balancing the budget has been the clear and generally accepted fiscal goal for many years in the United States, there is not yet agreement on the appropriate fiscal policy during a period of budget surpluses.

To help inform the current budget debate, GAO was asked to look at other countries with recent experience with budget surpluses. During the 1980s and 1990s, several advanced democracies achieved budget surpluses. Senate Budget Committee Ranking Member Lautenberg, subsequently joined by Chairman Domenici, asked that GAO examine the experiences of six nations that have achieved budget surpluses—Australia, Canada, New Zealand, Norway, Sweden, and the United Kingdom. Specifically, GAO was asked to determine (1) how they achieved budget surpluses and what their fiscal policies were during periods of surplus, (2) how they addressed long-term budgetary pressures, and (3) how they adapted their budget process during a period of surplus. GAO was also asked to identify lessons these nations learned from their experiences with budget surpluses that might be applicable to the United States.

Background

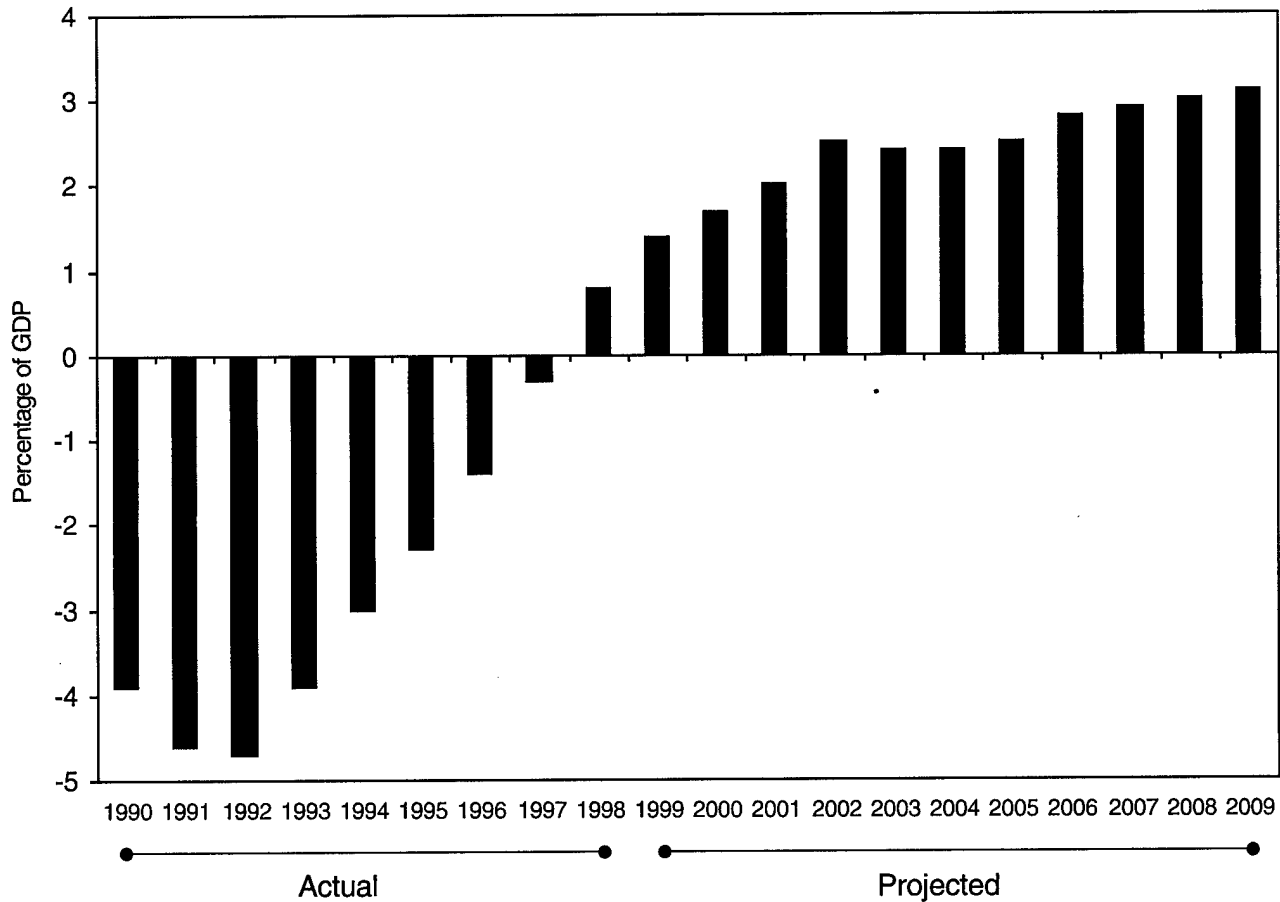
Balancing the budget is a fiscal goal that often commands broad support—at least in the abstract—from policymakers and the public alike. The idea of a government spending no more than it takes in has a near universal appeal across the political spectrum. In contrast, a government running a budget surplus—spending less than it takes in—is a goal with less intuitive appeal, and a policy that often lacks a natural constituency.

Following years of sustained deficit reduction efforts and as a result of strong economic growth, the United States achieved a budget surplus in 1998 following a prolonged period of deficits.¹ During that past 15 years, there has been a general consensus on the need to reduce budget deficits. Surpluses are now projected to continue for at least the next 10 years.² (See figure 1.) With the arrival of budget surpluses, a new political debate has emerged: Should surpluses be saved or spent? If they are spent, what should they be spent on? How should they be allocated among debt reduction, spending, and tax cuts? Can surpluses be used to address long-term fiscal pressures? Should the U.S. budget process be modified during a period of surpluses?

¹U.S. surplus figures are presented on a unified basis which includes both the on- and off-budget portions of the budget. The off-budget sector reflects the annual fiscal activities of the Social Security trust funds and the Postal Service.

²Assumes that surpluses are not spent and that budget caps are adhered to through 2002, after which time they are assumed to grow with inflation.

Figure 1: From Deficits to Surpluses: U.S. Unified Budget Balance as a Percentage of GDP, 1990 to 2009



Note: Figures for 1999 and beyond are estimates.

Source: *Fiscal Year 2000 Budget of the United States: Historical Tables*, Office of Management and Budget and *The Economic and Budget Outlook: An Update*, July 1, 1999, Congressional Budget Office.

The answers to these questions can have important consequences for the future economic and fiscal health of the United States. On the one hand, surpluses inspire proposals to allocate funds for current consumption on both the spending and revenue sides of the budget. On the other hand, the more of the budget surplus that is saved, the greater the long-term fiscal and economic benefits. From a budgetary standpoint, surpluses reduce

debt and lead to a reduction in interest costs, freeing up budgetary resources to be spent on other priorities.

Running surpluses can also help to increase economic growth in the long term. A budget surplus increases national saving and leads to an increase in the amount of funds available to be invested elsewhere in the economy. Lower government borrowing also puts downward pressure on interest rates, as there is less demand for available funds. Together, lower interest rates and higher saving and investment increase the capacity for economic growth over the long term.

Another benefit of reducing debt is the enhanced ability to meet future needs. The United States faces a significant challenge associated with an aging population that will result in significant spending pressures for public pension and health programs. Reducing debt today can strengthen our nation's capacity to finance the future burgeoning costs of health and retirement programs.

Results in Brief

Like the United States, other countries achieved budget surpluses largely as a result of improving economies and sustained deficit reduction efforts. As they entered a period of surplus, they also debated how surpluses should be used. The countries GAO studied have generally reached consensus on how they plan to use surpluses, and they have developed unique strategies that address national priorities. As part of their strategies, they have developed explicit goals to guide fiscal policy and have justified their goals with compelling rationales that often pointed out the potential fiscal and economic benefits of continued fiscal discipline. The case study countries generally chose to continue with a fiscally cautious approach, with three countries—New Zealand, Norway, and Sweden—aiming for sustained surpluses. New Zealand and Sweden have focused on the need to reduce debt as a justification for sustained surpluses, while Norway has focused on the need to save for long-term budget and economic pressures. To maintain support for their policies, these three countries have also devoted some portion of their surpluses to tax cuts and/or spending increases, addressing critical needs while still aiming for an overall general surplus.

Each of the case study countries has taken actions to address long-term budgetary and economic concerns. For Norway in particular, long-term budget and economic pressures were a major factor leading the government to decide that surpluses were needed to ensure the long-term

sustainability of its fiscal policies. For other countries, programmatic reforms aimed at addressing long-term pressures enacted prior to the arrival of surpluses resulted in increased fiscal flexibility during a period of surplus. Over the last two decades, four of the case study countries—Australia, Canada, Sweden, and the United Kingdom—have reformed their pension systems, improving their long-term sustainability. As a result, as these countries entered a period of surplus, their debate focused on other needs, such as reducing debt or addressing areas affected by past budget cuts. New Zealand, by focusing on using surpluses to reduce debt, has also taken action to improve its long-term economic and fiscal health.

Budget process reforms have played a key role in both framing the debate about surpluses and helping maintain fiscal discipline during periods of surplus. Each case study country changed its budget process during the 1990s in an attempt to better control spending and/or to guide fiscal policy decisionmaking. As countries entered a period of budget surpluses, these reforms played a critical role in guiding fiscal policy and maintaining fiscal restraint. As part of their new strategies, some countries chose to focus on measures of fiscal position other than year-end balance to justify continued fiscal discipline in times of surplus. For example, New Zealand focuses on its debt to GDP ratio, and Norway uses a structural measure that adjusts for the economy's impact on the budget.

Despite the many differences between the case study countries and the United States, the experiences of these nations can provide helpful ideas to be considered in our debate on whether to sustain surpluses and/or how to use them. GAO's study suggests that it is possible to sustain support for continued fiscal discipline during a period of surpluses while also addressing pent-up demands. However, a fiscal goal anchored by a rationale that is compelling enough to make continued restraint acceptable is critical. For each country in our study, the goal and the supporting rationale grew out of its unique economic experience and situation. Many in the United States have made the case for sustaining at least some portion of surpluses to help deal with our longer-term budgetary pressures, as reflected in the current debate over how to save the portion of the surplus derived from the Social Security program. GAO's long-term model simulations illustrate the need for continued fiscal restraint: saving some of the surplus is necessary along with structural reform of public retirement and health programs.

The United States is faced with the challenge of making the transition from a budget regime focused on eliminating the deficit to one that deals with

allocating the surplus between long-term pressures and short-term demands. While eliminating a deficit is arguably self-defining and straightforward, other nations' experiences suggest that sustaining even a portion of our surpluses calls for a different framework featuring explicit fiscal policy goals and targets to both inform the allocation of surpluses and to promote public acceptance of the choices. Such a framework would include an agreement on appropriate long-term fiscal goals to guide the more specific debate over the relative merits of different priorities—how much of the surplus to devote to reducing debt, increasing domestic discretionary or defense spending, securing existing unfunded entitlement promises, and cutting taxes.

As essential as fiscal targets may be for sustaining surpluses, they are not self-evident. Unlike budget balance where a single number may be an appropriate goal, decisions about sustaining a surplus may call for more complex measures. There is no single number like “0” in the surplus world. The debate has already begun over what might replace “0” deficit as an appropriate fiscal policy measure for the United States—and what process might be appropriate to achieve it. The experiences of other nations suggest that sustaining a surplus over time to address our own long-term needs calls for a framework which:

- provides transparency through the articulation and defense of fiscal policy goals;
- provides accountability for making progress toward those goals; and
- balances the need to meet selected pent-up demands with the need to address long-term budget pressures.

GAO Analysis

A Period of Budget Surpluses Led to New Fiscal Strategies

As countries have transitioned from an era of deficit reduction to a period of surplus they have developed unique strategies for how to use their surpluses. The countries in GAO's study found it important to set clear fiscal goals and to articulate compelling rationales explaining the potential long-term benefits of their policies in order to maintain public support for continued fiscal discipline.

In general, the countries decided to continue with a fiscally cautious approach. Three countries—New Zealand, Norway, and Sweden—set a goal

for continued annual budget surpluses. The other three—Australia, Canada, and the United Kingdom—set budget balance as their main fiscal goal, but as part of a cautious fiscal strategy that has resulted in them achieving small surpluses. Leaders in these countries pointed to the potential long-term economic and fiscal benefits as a compelling rationale to justify their policies, and there has generally been broad support for continued fiscal discipline during a period of surplus. However, the countries have generally made room for additional spending initiatives and/or tax cuts, in some cases to address perceived needs following a period of deficit reduction. Remarkably, several nations have instituted spending cuts to sustain surpluses during this period.

Addressing Long-term Pressures

Like the United States, most countries in our study face significant challenges arising from an aging population. While demographic trends differ among the countries, all are projecting an increase in the ratio of retirees to workers. If current spending patterns continue, increased spending on public pensions and health care threatens to crowd out spending on other important public goods and services.

Over the past two decades, the case study countries generally have taken actions that address long-term fiscal pressures expected to arise from an aging population. Surpluses have helped nations enhance future fiscal and economic capacity by reducing debt burdens. By reducing its debt burden, each country has taken a step toward improving its long-term fiscal and economic health and enhancing future budget flexibility. Budget surpluses increase national saving, which can lead to increased investment and productivity, thereby increasing potential future economic output and living standards. Budget surpluses also reduce the government's interest costs, freeing resources to be spent on other priorities. Furthermore, lower levels of debt can improve a nation's capacity to borrow and meet future budgetary needs.

Norway is explicitly attempting to use its budget surpluses to address long-term fiscal and economic concerns. The combined effects of an aging population and declining oil revenues are projected to result in an unsustainable fiscal path and eventual economic decline. To address this problem, Norwegian decisionmakers reached a broad consensus on the need to save projected surpluses and established a Petroleum Fund where budget surpluses are deposited and invested to pay for future budget needs.

Four other countries—Australia, Canada, Sweden, and the United Kingdom—enacted major pension reforms during the past two decades, which have reduced long-term budgetary pressures and put their pension systems on a more sustainable path. Australia and the United Kingdom carried out pension reforms in the 1980s and 1990s; and as they have entered a period of surpluses, long-term budgetary pressures due to increasing pension costs have not emerged as a major focus of political debates. Canada and Sweden have traditionally accounted for their pension systems separately from the government budget, and their pension fund assets have been invested outside the government. As a result, pension fund surpluses have not been included in their surplus debates. Each country was able to reform its pension system during the 1990s, placing its pension system on a more sustainable path. The United States has not yet engaged in fundamental reforms of our public pension and health systems. Such reforms are necessary to assure the sustainability of these important national programs and to relieve the related longer term budget pressures.

**Budget Process Both Guides
and Supports Fiscal
Strategy for Surplus**

The framework for fiscal decisionmaking, which includes both the budget process and the way fiscal position is measured, can play a critical role in the ability of a government to maintain fiscal discipline. In an effort to aid deficit reduction efforts, each country made important changes to its budget process during the 1990s, which were continued and adapted to a period of surplus. As these countries moved into a period of budget surpluses, their budget processes have continued to play an important role in maintaining fiscal discipline and/or in setting fiscal policy.

In Norway and Sweden, expenditure limits have continued to play a critical role as they attempt to run sustained surpluses. Bolstered by explicit spending limits, the renewed budget framework has enabled each country to maintain better control over spending during the current period of surplus. As Canada has entered a period of small surpluses, the government generally does not spend projected surpluses until they are about to materialize. The size of Canada's available surpluses appears low because the government's projections extend for only 2 years and are based on conservative economic forecasts. To the extent that the economy performs better than forecast, funds become available for new policy initiatives during the fiscal year.

The measure of fiscal position is important because it can be used to define a goal and to measure "success." Zero deficit is generally accepted as one such measure and a signal of the fiscal health of a country. However, during

periods of surplus, other measures are necessary to sustain some degree of fiscal restraint. In New Zealand, the statutory requirement that the government establish a "prudent" debt level as a fiscal goal has been critical to its ability to sustain fiscal discipline during a period of surpluses. Specifically, in 1994 the government established a debt goal of between 20 and 30 percent of GDP, and set as its fiscal policy to run surpluses until that goal was achieved. In 1996, when it became apparent that the 30 percent debt target would be achieved, the government enacted a tax cut and reset its debt target to 20 percent of GDP. Norway focuses on a structural measure of fiscal position, which removes the effects of the economy and petroleum activities, when setting fiscal policy. The government uses this measure to justify continued fiscal restraint during periods of strong economic growth and large budget surpluses. Finally, Canada and Sweden account for their public pension funds separately from the general fund, and as a result, their surplus debates have focused on other issues.

Implications for the United States

Like the nations in GAO's study, the United States has turned years of deficits into a surplus; but unlike most of these nations, U.S. policymakers have not yet reached agreement on goals and targets to allocate the use of our surpluses. Over the last 15 years, fiscal policy in the United States has focused on the need to reduce—and eventually eliminate—the deficit.

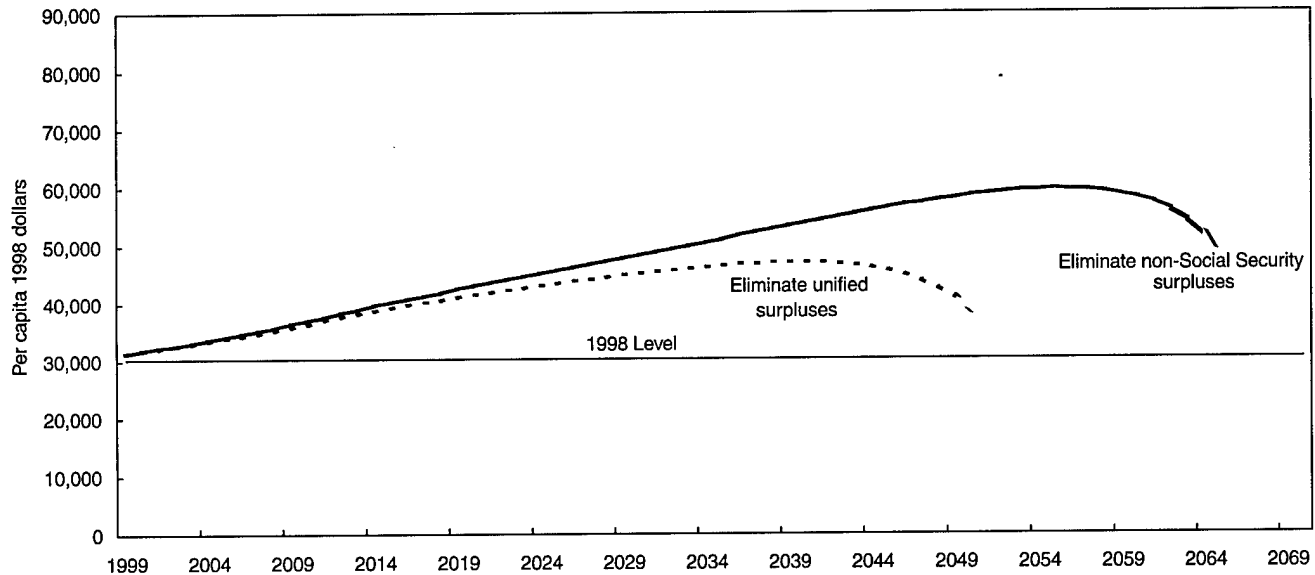
Furthermore, pent-up demands for federal policy actions accumulated during years of deficits. Although the United States is still operating under the rules established to achieve budget balance, the advent of a surplus has led to increased pressure for spending increases and/or tax cuts. The legitimacy of the restraints adopted to rescue the nation from deficits is increasingly questioned as surpluses build up. The unified budget reached balance earlier than expected, and the Congress and the President now face the difficult situation of having to comply with tight spending caps designed to eliminate deficits at the same time that the budget is in surplus.

The experiences of other nations suggest that it is possible to sustain support for continued fiscal discipline during a period of surpluses while also addressing pent-up demands. A fiscal goal anchored by a rationale that is compelling enough to make continued restraint acceptable is critical. Many in the United States have made the case for sustaining at least the portion of surpluses resulting from annual Social Security surpluses to help deal with our longer-term pressures.

GAO's long-term model simulations illustrate the need for continued restraint: saving some of the surplus is necessary along with structural reform of retirement and health programs. GAO's simulations show that saving a good portion of the projected surpluses would strengthen the nation's capacity to finance the burgeoning costs of health and retirement programs prompted by the aging of our population. For instance, GAO has estimated that national income would be nearly \$20,000 higher per person in real terms by 2050 if the Social Security portion of the budget surplus is saved—that is, eliminate the non-Social Security surplus—compared to a unified budget balance position.³ (See figure 2.) Moreover, there is widespread recognition in the United States of the need to address long-term budget drivers—Social Security and Medicare—because even if surpluses are “saved” and used to pay down debt, growth in these programs threatens to crowd out discretionary spending. (See figure 3.)

³Assumes that permanent unspecified policy actions (that is, spending increases and/or tax cuts) are taken through 2009 that eliminate the on-budget–non-Social Security–surpluses. Thereafter, these unspecified actions are projected through the end of the simulation period. On-budget deficits emerge in 2010, followed by unified deficits in 2019.

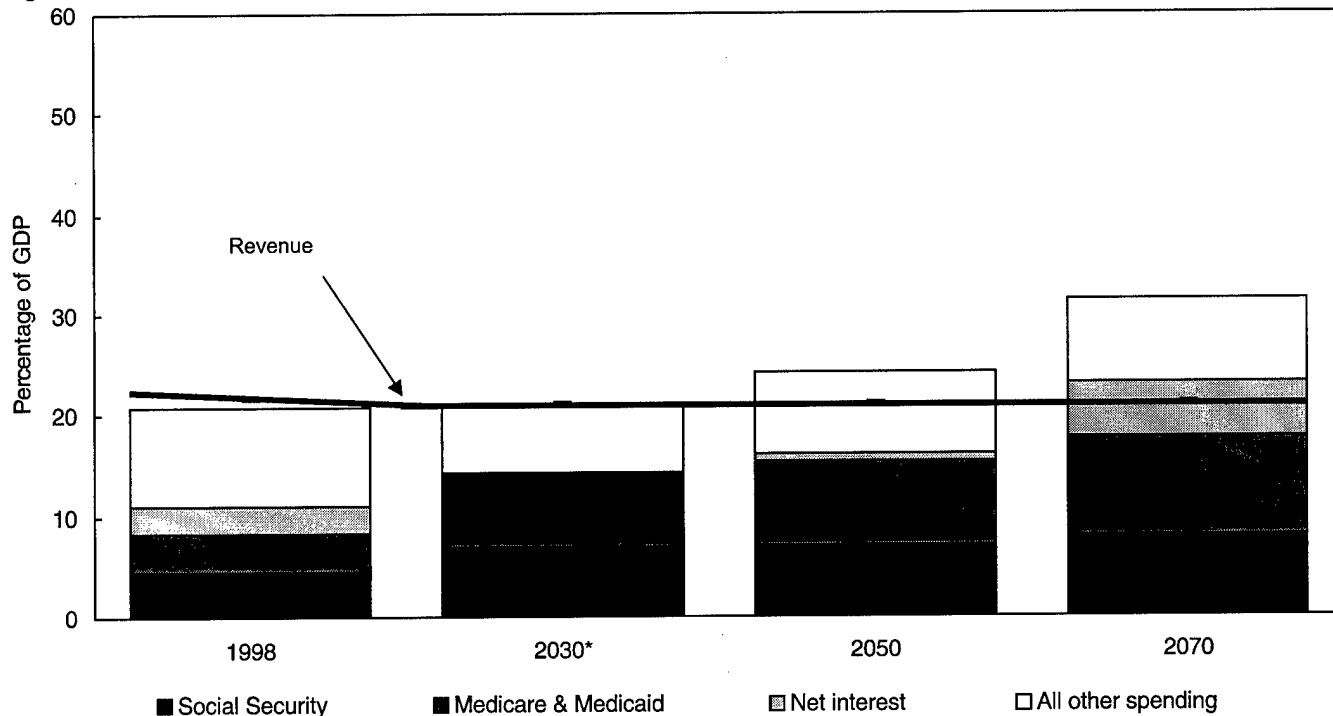
Figure 2: GDP per Capita Assuming Non-Social Security Surpluses are Eliminated Versus Unified Budget Balance



Note: The "eliminate non-Social Security surpluses" path assumes that permanent unspecified policy actions (that is, spending increases and/or tax cuts) are taken through 2009 that eliminate the on-budget surpluses. Thereafter, these unspecified actions are projected through the end of the simulation period. On-budget deficits emerge in 2010, followed by unified deficits in 2019. The "eliminate unified surpluses" path assumes that surpluses are not retained, but that the unified budget remains in balance through 2008.

Source: GAO analysis.

Figure 3: Composition of Spending as a Share of GDP, Assuming On-budget Balance



Note: Revenue as a share of GDP falls from its actual 1998 level to CBO's 2008 implied level and is held constant at this level for the remainder of the simulation period.

*In 2030, all other spending includes offsetting interest receipts.

Source: GAO Analysis.

Therefore, a challenge for the United States is to find a way to make the transition from a budget regime focused on eliminating the unified deficit to one that deals with allocating the surplus between long-term pressures and short-term demands. Agreement on appropriate long-term fiscal goals is important to both inform the allocation of surplus and promote public acceptance of the choices. For the United States, overall fiscal targets could guide the more specific debate over the relative merits of different priorities—how much of the surplus to devote to reducing debt, increasing domestic discretionary or defense spending, securing existing unfunded entitlement promises, and cutting taxes. These choices could be considered within a broader context that considers tradeoffs between current consumption and saving for the future.

The design and use of fiscal targets requires care. U.S. experience shows that a target cannot replace agreement on the steps necessary to achieve it. In order for any fiscal policy goal to govern actions, it must be grounded in a discussion of national needs and the tradeoffs associated with reaching such a goal. In addition, selecting the appropriate measures in a time of surplus is complicated—indeed a surplus period may call for more complex measures. In our nation's setting, targets could provide a renewed focus for fiscal policy geared to monitoring and enhancing long-term U.S. economic and fiscal capacity to shoulder the increased obligations associated with the retirement of the baby boom generation. Although it is not easy, the countries in GAO's study sought to design a framework strong enough to guide action but flexible enough to survive when economic conditions or other factors change. In our setting, the current debate over saving the Social Security surplus may ultimately yield an agreement on both fiscal targets as well as a process for sustaining support for these targets over time.

Conclusions

Can the experiences of these nations be translated to the U.S. environment? What do their experiences say about the next steps in the U.S. debate? First, the failure to define an explicit fiscal path for the future has serious downside risks. As GAO has discussed in this and other reports, "doing nothing" is not really an option—long-term pressures will overwhelm the budget absent reform of public pension and health programs. While the debate has begun on how to save a portion of the surplus, until the fiscal path for a period of budget surpluses is fully and clearly articulated there is a risk of losing the opportunity to enhance our long-term economic well-being. A number of the case study countries had already dealt with reform of their pension or old-age support programs; this made their task easier. This has not been done yet in the United States and so policymakers must factor the pressures associated with such programs into any new fiscal framework.

As the United States considers how to use surpluses to address our own long-term needs, the other nations' experiences suggest a framework which:

- provides transparency through the articulation and defense of fiscal policy goals;
- provides accountability for making progress toward those goals; and
- balances the need to meet selected pent-up demands with the need to address long-term pressures.

As the United States moves from deficit to surplus, it will be important for policymakers to reach agreement on a clearly defined and transparent fiscal policy framework that makes sense in light of both the current pressures and the long-term projections. In order for this framework to succeed in setting a broad set of principles to guide fiscal policy decisionmaking, the rationale for it must be explained and defended.

Within this new framework, clear fiscal policy goals should be articulated. As with the other countries in GAO's study, these goals should not be rigid fixed targets to be achieved on an annual basis. Rather, they should consist of broader goals defining a future fiscal policy path for the nation. The goals can provide an accountability framework strong enough to guide annual budget targets but flexible enough to survive when economic conditions and other factors change. Without this balancing of needs, the strains on the enforcement regime become too great and the discipline to follow a glide path to achieving national goals may be weakened. In other countries these goals included reducing the burden of national debt, maintaining international investor confidence, and increasing the national saving rate. Although the prospect of a loss in international investor confidence is not as threatening to the United States as it might be for other nations, goals and measures relevant to our own long-term fiscal outlook need to be explored. Such goals would go beyond "0" budget balance to focus on such issues as debt burden, questions of intergenerational equity, and contributions of fiscal policy to net national saving. The use of structural measures of fiscal position might help keep fiscal policy focused on the underlying fiscal position of the federal government, excluding temporary cyclical economic trends.

The surplus presents an opportunity to address the long-term budget pressures presented by Social Security and Medicare. If we let the achievement of a budget surplus lull us into complacency about the budget, then in the middle of the 21st century, we could face daunting demographic challenges without having built the economic capacity or program/policy reforms to handle them. A new fiscal framework for a period of budget surpluses would be of great value to policymakers and to the U.S. public as the nation embarks on a period of budget surpluses. Such a framework could go a long way towards ensuring that future debate on what to do with surpluses is focussed on issues that are most critical to advancing the future economic well-being of the nation.

Developing consensus on a new fiscal goal and putting in place a framework to support such a goal is not easy. Other nations' experiences

Executive Summary

illustrate, however, that reaching consensus on using surpluses is possible. However, GAO would note that our nation has made measurable sacrifices of current needs for future goals when those goals were defined in compelling enough terms. A surplus offers the United States a unique opportunity to revisit the framework under which budgetary decisions are made and to address selected critical short- and long-term needs.

Introduction

During the 1980s and 1990s, several advanced democracies achieved budget surpluses. Several of these countries have been able to sustain surpluses over a period of several years and have set a fiscal policy goal calling for sustained surpluses. They have been able to justify sustained surpluses despite obvious difficulties associated with continued fiscal restraint. A discussion of how and why these countries were able to justify continued fiscal discipline can provide insights to U.S. policymakers as they continue to debate fiscal policy during the current period of projected budget surpluses.

Senate Budget Committee Ranking Member Lautenberg, subsequently joined by Chairman Domenici, asked that we examine the experiences of six nations that have achieved budget surpluses in the 1980s and 1990s—Australia, Canada, New Zealand, Norway, Sweden, and the United Kingdom—and to identify lessons these nations learned from their experiences with budget surpluses that might be applicable to the United States.

The Politics of Running a Budget Surplus

Balancing the budget is a fiscal goal that often commands broad support—at least in the abstract—from policymakers and the public alike. The idea of a government spending no more than it takes in has a near universal appeal across the political spectrum. In contrast, a government running a budget surplus—spending less than it takes in—is a goal with less intuitive appeal, and a policy that often lacks a natural constituency. During periods of surplus, a government hears many calls for new spending or tax cuts. This may reflect in part a reaction to a period of restraint and the often difficult steps taken to eliminate deficits. In the face of these calls to respond to deferred demands, it can be difficult for politicians to justify running a surplus.

The politics of surplus are very different from the politics of deficits. During a deficit reduction period the goal is clear and political decisions tend to focus on the mix and severity of spending cuts and tax increases needed to bring the budget into balance. While there may be disagreement over the detailed actions to be taken and how long it should take to achieve balance, there is generally agreement on the goal of balance. During a surplus period, the political debate focuses on whether surpluses are needed at all. If consensus is reached on the need for surpluses, then agreement can be reached on how long they are needed and how large they should be. The answers to these questions are not obvious as there is no single goal with the intuitive appeal of a balanced budget or zero deficit.

While most economists agree that there are economic and fiscal benefits of running a surplus, these benefits are longer term and must compete with current needs. The potential economic benefits of running a surplus include lower real interest rates, a larger pool of domestic savings to finance productive investment, and, ultimately, improved prospects for higher economic growth and living standards in the future. Running surpluses can also lead to budgetary benefits, including lower interest payments and increased future budgetary flexibility. Consequently, it may be politically difficult to justify sustained surpluses because the benefits will occur in the future and/or there is not always a strong political constituency to support these goals. Furthermore, these benefits must be weighed against calls for spending increases or tax cuts, which are usually supported by organized political advocates and can have more immediate political benefits.

Support for retaining a surplus can be further weakened by the fact that many countries achieve surpluses after several years of painful deficit reduction efforts. Popular programs may have already been cut and/or taxes raised to achieve surplus. Electorates willing to accept relatively tight fiscal discipline to achieve balance may be unwilling to continue to do so when there is "excess" money at the end of the year. This "fiscal fatigue" can greatly increase the pressure to "spend" the surplus. Consequently, governments that adopt a surplus goal often allow a portion of surpluses to be used for spending increases or tax cuts.

The Benefits of Running a Budget Surplus

Countries with budget surpluses can expect to receive both fiscal and economic benefits. From a budgetary standpoint, the fact that surpluses reduce debt means that the associated interest cost falls, freeing up resources to be spent on other priorities.¹ A high interest burden tends to lead to even higher deficits and debt, which, in turn, contribute to rising interest costs—creating a “vicious cycle” of increasing deficits and debt. Replacing deficits with surpluses reduces debt and begins a “virtuous cycle” where lower levels of debt lead to lower interest payments—possibly at lower interest rates.² These lower interest payments in turn lead to larger potential surpluses and/or increased budget flexibility.

Running surpluses can also help to increase economic growth in the long term. A budget surplus increases national saving, and leads to an increase in the amount of funds available to be invested elsewhere in the economy. Lower government borrowing also puts downward pressure on interest rates, as there is less demand for available funds. Together, lower interest rates and higher saving and investment increase the capacity for economic growth over the long term. Increased national saving results in increased private investment and raises productivity, thereby increasing future economic output and living standards.

Another benefit of reducing debt is the enhanced ability to meet future needs. Many countries face the challenge of an aging population that brings with it significant spending pressures for pension and health programs. As their populations age, countries face a declining number of workers relative to retirees at the same time people will live longer in retirement. If these countries enter the period of the baby boom retirement with large debt loads, the relatively smaller working generation would face a twin challenge of supporting the pension and health care needs of retirees and paying the interest expenses on a large debt. Reducing debt today can increase a nation's fiscal capacity to afford future budget pressures. Thus, budget surpluses can have an important effect on intergenerational equity by helping countries prepare for future challenges.

¹There is not always a one-to-one relationship between the size of a budget surplus and the amount of debt reduction due to accounting differences between the two measures. Debt is a cash measure of the government's borrowing needs. Measures of budget surpluses sometimes include non-cash items, such as the subsidy amount of government loans instead of the cash value of those loans.

²Just as deficits put upward pressure on interest rates, a period of budget surpluses should relieve this pressure. Lower interest rates then reduce interest costs.

Also, surpluses can have a positive impact on investor confidence because of the long-term fiscal and economic benefits that could result and because surpluses can be perceived as an indicator of good fiscal management. Increased investor confidence can lead to lower interest rates and reduce the cost of borrowing.

Finally, using surpluses to reduce debt burden allows a country to be better equipped to handle future economic shocks. If debt is at a manageable level, countries have a greater ability to increase borrowing during recessions. If debt is at a high level, there is the risk that additional borrowing will be at higher interest rates as investors demand a premium to cover the risk of nonpayment.

Why the Experiences of Other Countries Are Relevant to the United States

The United States is currently entering a period of projected budget surpluses for the first time in many years.³ Since the arrival of surpluses in 1998, there has been much debate about whether surpluses should be maintained and how they should be used. To better inform our current debate, it is instructive to look at other countries with recent experience with budget surpluses. How did they reach consensus on the use of surpluses? What strategies did they employ to carry out their fiscal policy during a period of surplus? Have they taken steps to address their long-term budgetary pressures? How have they used their budget process to maintain fiscal discipline during a surplus period? The answers to these questions offer important insights as the national debate continues.

We chose six case study countries—Australia, Canada, New Zealand, Norway, Sweden, and the United Kingdom—because they have all recently experienced budget surpluses. Admittedly, the six case study countries differ from the United States in many ways. They are all smaller and more dependent on foreign trade. The role of the central government varies from country to country. Two countries—Australia and Canada—have a federal system similar to ours, while the other four countries have unitary systems, with the central government playing a key role in financing local sector activities. When all levels of government are combined, the case study countries generally have a larger public sector than the United States.

³Prior to 1998, the United States has achieved budget surpluses in 8 years since the Great Depression. The most recent surplus occurred in 1969, and the longest period of surpluses lasted 3 years from 1947 to 1949.

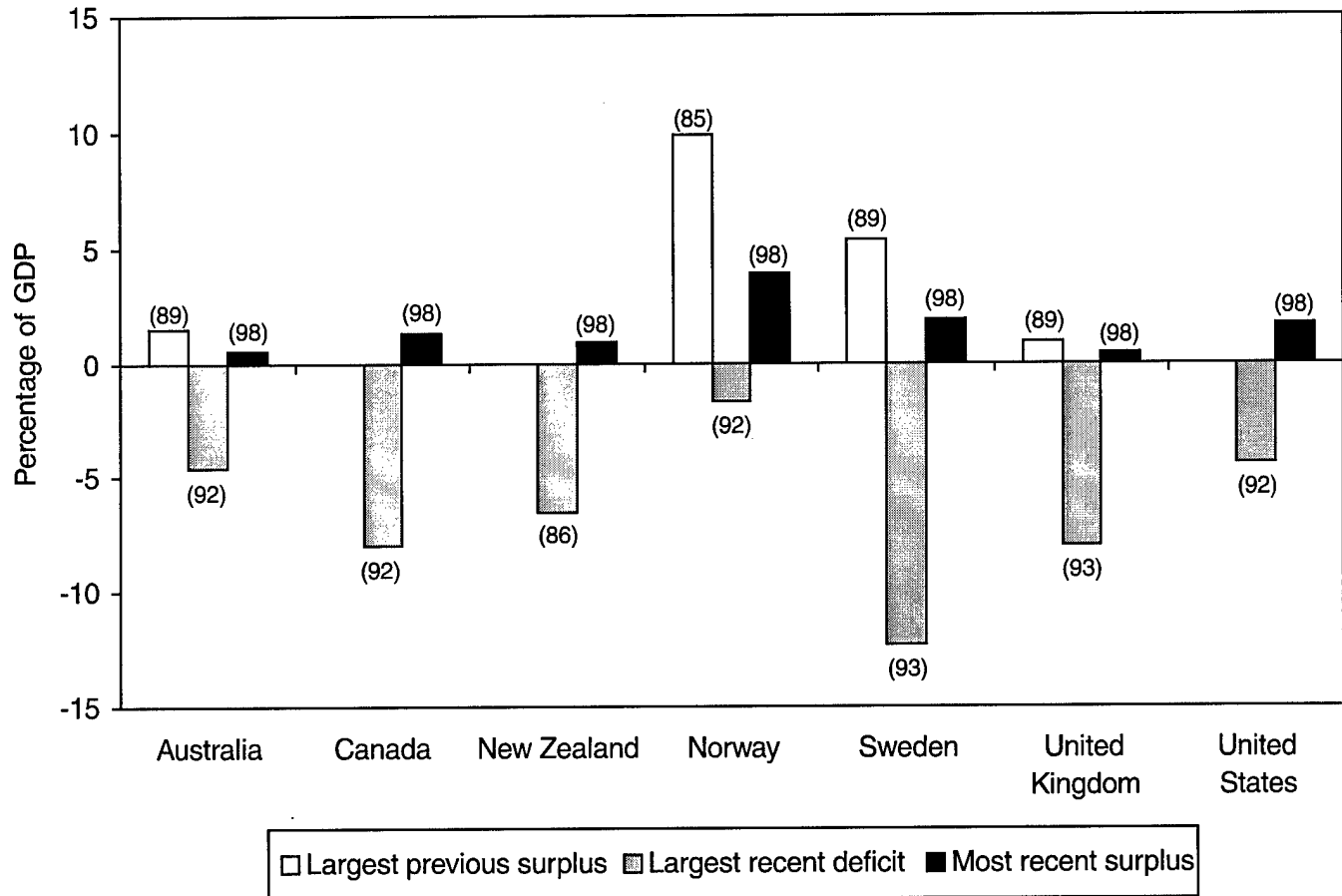
Another key difference is that all six case study countries have parliamentary systems of government. Some might express skepticism about the transferability of experiences between different systems of government. Parliamentary systems are thought to facilitate controversial political action by consolidating power in the hands of the governing party. In contrast, the U.S. system's separation of powers is thought by some to present leaders with greater obstacles to political agreement. Yet imposing sacrifice, even during a period of surplus, is a difficult task for any democratically elected government. Furthermore, coalition or minority governments can form in some case study countries resulting in confrontation and controversy between the coalition partners. Coalition or minority governments routinely must seek the support of other political parties in order to enact legislation, and as result can act in a similar fashion to our system of separate legislative and executive branches.

Each of these differences can have an impact on the relative need for surpluses and the ability to achieve and sustain them. However, despite our differences, the experiences of these countries provide many important lessons for us to consider as we continue with our current budget debate. Like us, they achieved budget surpluses largely due to sustained deficit reduction efforts and a period of strong economic growth. They are all democracies with modern economies. Most face many of the same long-term challenges associated with an aging population as we do.

Fiscal History and Condition of the Case Study Countries

As of 1998, each of the case study countries has a budget surplus. Norway and New Zealand have had surpluses since 1994, the longest periods of sustained surpluses among the case study countries. The other four countries achieved budget surpluses in either 1997 or 1998. Four of the six case study countries achieved budget surpluses in the late eighties and then returned to deficits in the early nineties. (See figure 4.)

Figure 4: Shifts in General Government Financial Balances



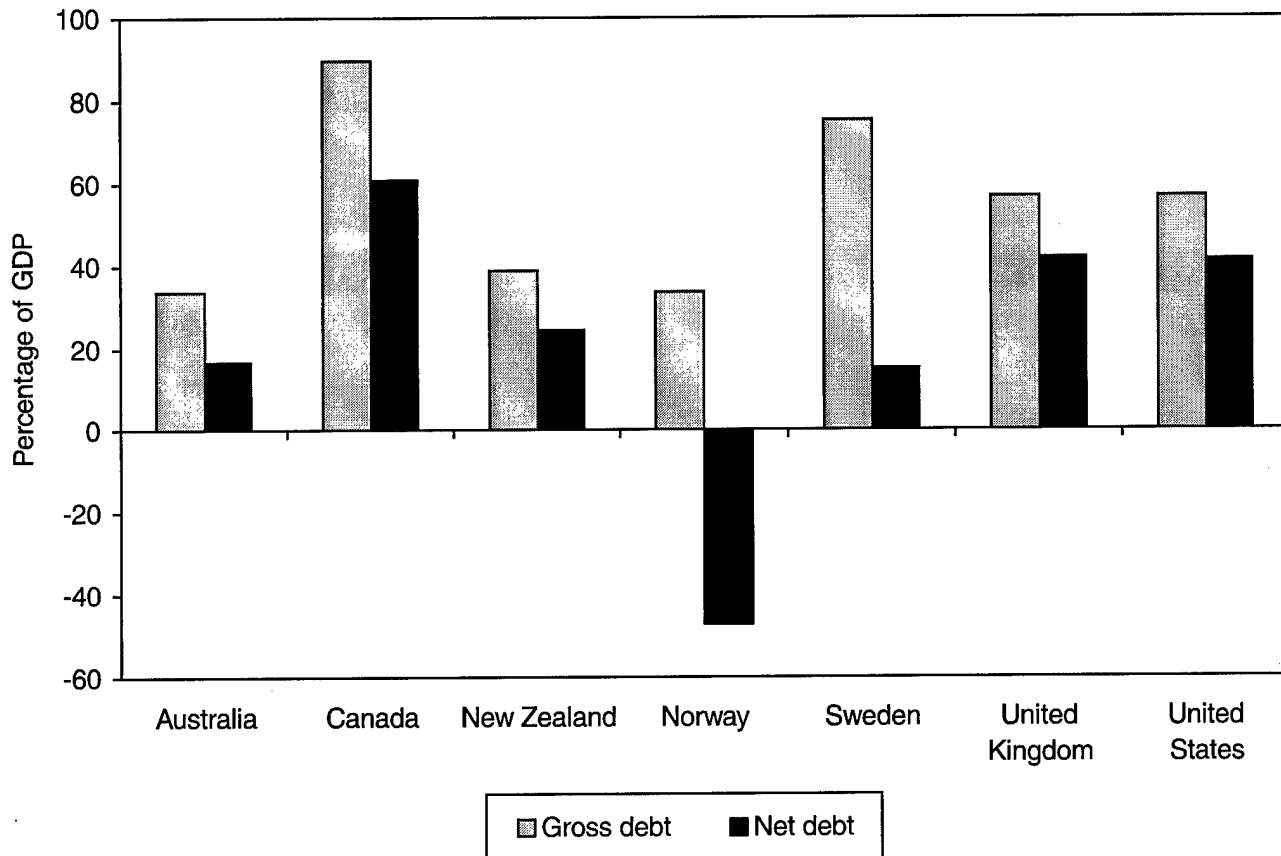
Note: Data for 1998 are estimates. General government financial balance accounts for all levels of government.

Source: OECD Economic Outlook 65, June 1999.

Debt burden varies from country to country. As of the end of 1998, general government gross debt as a percent of gross domestic product (GDP) ranged from a high of nearly 90 percent in Canada to less than 35 percent in Australia and Norway. General government gross debt includes the debt of the central government and all sub-levels of government, such as states and provinces, counties, and cities. However, it is also instructive to look at net debt, which accounts for government owned financial assets, such as loans, stocks, and bonds, because it provides a better picture of the

government's net financial impact on the economy. As of 1998, general government net debt ranged from a high of about 60 percent of GDP in Canada to a low of about negative 47 percent in Norway—meaning that Norway owns more than enough financial assets to completely pay off its debt. See figure 5 for each country's most recent general government gross and net debt figures.

Figure 5: 1998 General Government Gross and Net Debt as a Percent of GDP



Note: Data for Norway, Sweden, the United Kingdom, and Australia are estimates. Net debt includes government financial assets, such as loans, stocks, and bonds. Norway's net debt is negative because it owns more financial assets than it has debt outstanding.

Sources: *OECD Economic Outlook 65*, June 1999, and New Zealand Treasury.

Economic and Fiscal Characteristics of the Case Study Countries

The case study countries are smaller, more reliant on trade, and have a larger public sector than the United States. (See table 1.) The United Kingdom has the largest population of the case study countries while New Zealand has the smallest, with a population about 1/16 the size of the United States. The economies of the case study countries are also smaller, with the United Kingdom the largest at about 16 percent of the United States economy and New Zealand the smallest at less than 1 percent of the United States economy. The economies of the case study countries are more dependent on trade than the United States with exports as a percentage of GDP ranging from almost two times to more than four times that of the United States.

Table 1: Characteristics of the Six Case Study Countries and the United States, 1997

	Population (in thousands)	GDP (billions \$US)	Exports (% GDP)	Public Sector Outlays (% GDP)
Australia	18,532	392.9	15.6	33.5
Canada	30,287	607.7	35.5	42.3
New Zealand	3,761	65.0	21.8	38.9
Norway	4,393	153.4	31.6	43.6
Sweden	8,848	227.8	36.4	62.3
United Kingdom	58,105	1,282.9	22.1	41.0
United States	266,792	7,824.0	8.8	33.6

Note: Outlay figures are for all levels of government.

Sources: *OECD Economic Outlook 65*, June 1999 and various countries' OECD economic surveys, 1999.

Public sector spending for all levels of government as a percentage of GDP is smaller in the United States than in any of the case study countries except Australia, which has about the same level of public spending. This generally reflects a larger role for the governments of the case study countries. For example, the case study countries provide universal health care coverage for their citizens and many provide more generous social benefits.

A large public sector can affect fiscal position and fiscal policy in significant ways. Generally, a larger public sector results in wider swings in fiscal position corresponding to swings in the economy. Programs that are

economically sensitive—such as unemployment benefits and income taxes—add to the size of deficits during downturns and surpluses during periods of strong growth. These economically sensitive programs act automatically to stabilize the economy by increasing aggregate demand during weak periods and decreasing demand during periods of strength. The larger these so-called “automatic stabilizers” are relative to the economy, the larger the swing in fiscal position can be. For example, Sweden with public sector outlays accounting for about two-thirds of the economy, went from a deficit of over 12 percent of GDP in 1994 to a surplus of nearly 2 percent of GDP in 1998.

Definition of a Budget Surplus

In its simplest definition, a surplus is an excess of revenue over spending in a given period. However, definitions of revenue and spending vary among countries, and to compare across countries we used OECD data wherever possible. OECD data are presented on a general government basis, which includes the aggregate fiscal balances of all levels of government in that nation. In analyzing the experiences of the individual nations we focused on the measure of fiscal position used by the central government, which formed the basis for policy debates. The definition of budget balance varies significantly from country to country, and can have an impact on the nature of the budget debate during a period of surplus. For example, Canada excludes surpluses in its public pension system from its primary measure of fiscal position. More detailed information on the measure of fiscal position used by each of the six countries is provided in appendixes I through VI, and chapter 4 contains a discussion of how the different measures can have an impact on the budget debate.

Objective, Scope, and Methodology

Senators Domenici and Lautenberg asked us to review the experiences of six countries that had achieved budget surpluses. Specifically, they asked us to

- determine how these countries achieved a budget surplus and developed fiscal policies in periods of surpluses,
- determine how other countries have addressed long-term budgetary pressures and adapted their budget process during a period of surplus, and
- identify lessons these nations learned from their experiences with budget surpluses that might be applicable to the United States.

To accomplish these objectives, we reviewed OECD data on the case study countries' fiscal position, and in each country we interviewed officials and analysts familiar with their government's actions. We also interviewed and obtained documentation from government officials to better understand how countries developed fiscal strategies during periods of budget surpluses. We interviewed and obtained data and information from public policy critics, academicians, journalists, and members of political opposition parties to obtain their views. We reviewed a wide array of reports and economic analysis on fiscal and economic policy in general and on the specific case study countries. Experts from each case study country reviewed the appendix on their country, and experts in comparative public policy reviewed our analysis and findings. The reviewers generally agreed with our work, and we have incorporated their comments where appropriate.

In this report, we present significant fiscal policy actions taken by the six countries, either in terms of size, political importance, or economic impact. While the report does not fully detail all of the economic policies of the case study countries, we outline elements of the economic situation and policies which best helps explain how the countries chose their particular fiscal path.

Our work was conducted in the six case study countries and Washington, D.C., from March 1998 through October 1999 in accordance with generally accepted government auditing standards.

Countries Developed Strategies for Surplus

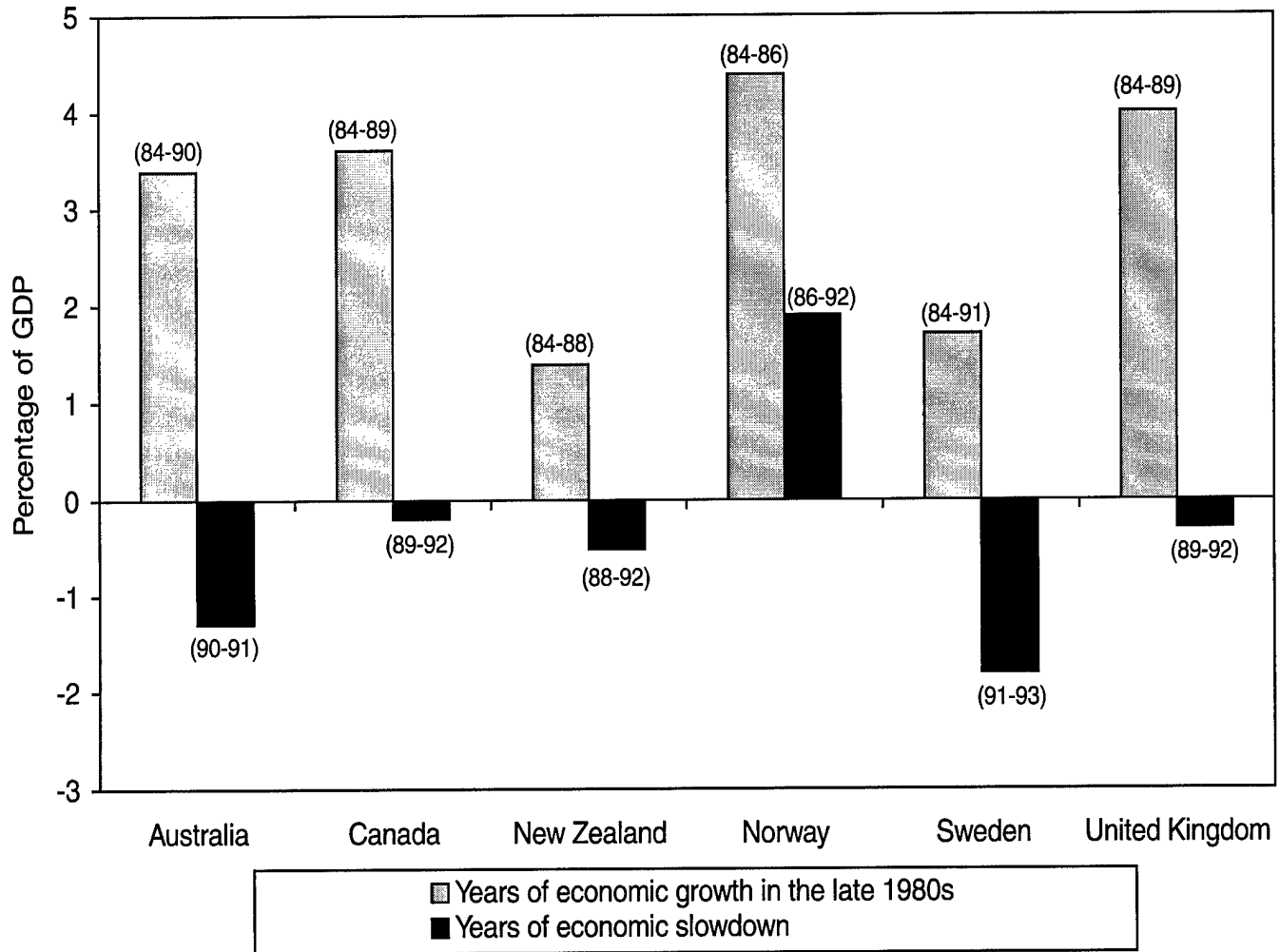
In the case study countries, the early 1990s were characterized by slow economic growth and large budget deficits. In response, policymakers enacted structural reforms and deficit reduction packages designed to improve economic and fiscal performance. As each case study country approached budget surplus in the 1990s, its government was faced with a decision about how to approach fiscal policy. The previous period of slow economic growth and large budget deficits continued to play a critical role in shaping how the case study countries approached surpluses, and they generally chose to continue on fiscally cautious paths.

As countries have transitioned from an era of deficit reduction to a period of surplus, they have developed unique strategies for how to use their surpluses. Case study countries have found it important to set clear fiscal goals and to articulate compelling rationales explaining the potential benefits of their policies in order to maintain public support for continued fiscal discipline. These countries have generally recognized the importance of competing priorities and have devoted some portion of their surpluses to tax cuts and/or spending increases rather than attempting to reserve the entire surplus for debt reduction. Some nations have been able to sustain surpluses for several years and have taken the difficult step of enacting cuts to maintain surpluses. The budget process has played a critical role guiding fiscal policy and/or supporting continued fiscal discipline.

Factors That Shaped the Surplus Debate During the 1990s

The political debate surrounding a budget surplus was influenced greatly by the economic slowdowns and budget deficits of the late 1980s and early 1990s. Each country we studied experienced a significant economic slowdown during this period, generally coinciding with a broader worldwide economic slowdown. (See figure 6.) In several countries the slowdown became severe. Sweden, for example, experienced 3 consecutive years of negative growth beginning in 1991. In other countries, including New Zealand and Norway, there were prolonged periods of below-average growth.

Figure 6: Change in Average Annual GDP Growth During Economic Slowdown of Late 1980s and/or Early 1990s



Source: *OECD Quarterly National Accounts, Number 3, 1998*, and *OECD National Accounts, Main Aggregates Volume I, 1960-1996*.

In several case study countries, a loss of investor confidence in fiscal and economic health added to the economic downturn, and fiscal and monetary policies were tightened in reaction to investors pulling money out of the country. Policymakers were limited in their ability to respond to an economic slowdown because they were forced to take procyclical actions to win back investor confidence. For example, both Norway and Sweden

were pursuing a policy of fixed exchange rates when a drop in investor confidence resulted in downward pressure on currency valuations. To support the value of the currency, each country raised interest rates, which had the effect of further slowing the economy. New Zealand and Sweden received credit downgrades due to concerns over their economic and fiscal health. Interest rates rose as a result, increasing the cost of borrowing and causing the economies to slow further. Also, several countries took actions to reduce budget deficits during the economic downturn, which slowed the economies further. These events made decisionmakers keenly aware of the need to sustain foreign investor confidence in their economic and fiscal policies.

The economic slowdowns of the late 1980s and early 1990s were a major factor leading to the reemergence of large budget deficits in the case study countries. In four countries, deficits followed a period of budget surpluses. For these countries, spending increases and/or tax cuts made during a period of surplus also contributed to the reemergence of deficits. The reemergence of large budget deficits was seen as a step backward following years of progress reducing budget deficits.

In reaction to slow economic growth, large budget deficits, and a drop in investor confidence, leaders in the case study countries took actions to restore fiscal and economic health. In general, the pervasive philosophy was that in order to sustain economic growth, inflation rates had to be kept low and stable and efforts taken to reduce budget deficits. To show their commitment to reducing inflation rates, five case study countries set explicit inflation targets and increased the independence of the central bank to respond to inflationary pressures. Each country also renewed deficit reduction efforts and implemented budget process changes to reinforce their commitment.

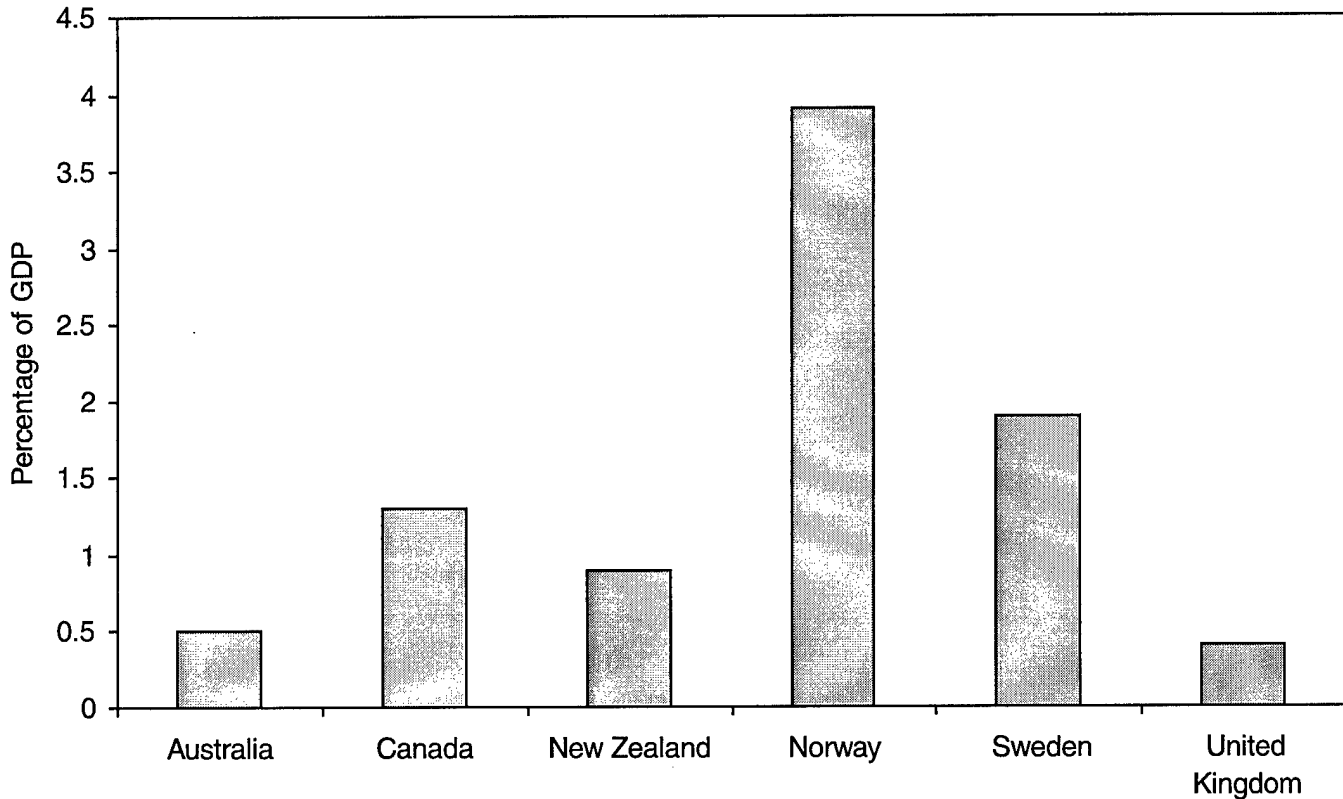
Several countries enacted large deficit reduction packages in response to the large deficits that had built up. For example, in 1994, Sweden enacted a deficit reduction package amounting to 7 percent of GDP over 4 years. Similarly, in 1994, the Canadian government introduced a package reducing the deficit by over 3 percent of GDP over 4 years, while the New Zealand government reduced its budget deficit by more than 4 percent of GDP from 1991 through 1993. In the other countries, the deficit reduction packages were relatively smaller and more gradual.

Leaders in each country enacted difficult spending cuts and/or tax increases in their efforts to bring the budgets back into balance. The New

Zealand government cut fiscal year 1991-92 net spending by 10 percent from the level projected in October 1990 and delayed implementation of a campaign promise to eliminate an unpopular surcharge on public pensions. Australia reduced expenditures in health, education, and employment services. Canada cut the federal workforce by 15 percent and cut back aid to provinces significantly, which had the effect of reducing spending on health care. Likewise, Sweden enacted a deficit reduction package that included reductions in subsidies for medical and dental care, indexation of certain taxes, and increased contribution rates for the unemployment benefit system.

A strengthening economy combined with deficit reduction efforts contributed to a significant improvement in fiscal position in each of the case study countries. By 1998, all of the case study countries had achieved a budget surplus. (See figure 7 for the fiscal position as of 1998 for each country.)

Figure 7: 1998 General Government Financial Balance



Source: *OECD Economic Outlook 65*, June 1999.

Countries Developed Fiscal Strategies for a Period of Surplus

As noted in chapter 1, balancing the budget is a fiscal goal that often commands broad support from both policymakers and the public alike. In contrast, a government running a budget surplus—spending less than it takes in—is a goal with less intuitive appeal, and a policy that often lacks a natural constituency. As case study countries entered a period of budget surpluses, decisionmakers had to decide what their fiscal policy goals would be. The previous period of slow economic growth and poor fiscal condition continued to influence fiscal policy.

As each country entered its current period of surplus, it has developed unique strategies to help ensure continued fiscal progress. Leaders in these countries have developed fiscal goals to help guide budgetary decisions

during a period of surplus. In general, the case study countries decided to continue with a fiscally cautious approach. Three countries—New Zealand, Norway, and Sweden—set a goal for continued budget surpluses. The three others—Australia, Canada, and the United Kingdom—each set balance as its main fiscal goal, but as part of a cautious strategy that has resulted in them achieving small surpluses.

Leaders in these countries have pointed to the potential economic and fiscal benefits as a compelling rationale to justify their policy, and there has generally been broad support for continued fiscal discipline during a period of surplus. Often, countries retained features of their budget process designed to aid deficit reduction efforts. The case study countries have generally made room for additional spending initiatives and/or tax cuts, sometimes to address perceived needs following a period of deficit reduction. Remarkably, several nations have instituted expenditure cuts to sustain surpluses during this period.

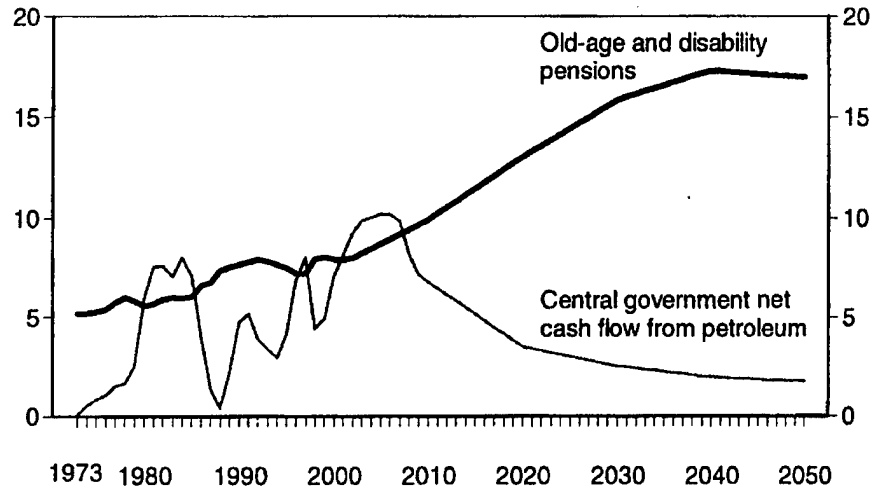
Three Countries Aim for Budget Surpluses

New Zealand, Norway, and Sweden have each set sustained surpluses as their primary fiscal policy goal. Following a period of economic and fiscal crisis, broad consensus was reached on the need for sustained surpluses. Leaders in these countries chose to pursue surpluses to address long-term fiscal and economic concerns, reduce debt, and/or sustain investor confidence in their fiscal management.

Norway Aims for Surpluses to Address Long-term Fiscal and Economic Concerns

Norway has established a goal of sustained surpluses in order to build up savings to address long-term fiscal and economic concerns resulting primarily from an aging population and declining petroleum revenues. (See figure 8.) Norway projects both a near doubling of retirement benefits from about 7 percent of GDP currently to about 15 percent of GDP by 2030 and a parallel decline in oil revenues from about 8 percent of GDP to less than 1 percent over the same period. Also, Norway is concerned that economic growth could decline in the long run if a strong petroleum industry crowds out investment in other industries. The combined effects of an aging population and declining oil revenues are projected to result in an unsustainable fiscal path and eventual economic decline. This long-term problem has been clearly communicated to policymakers and the public and has developed as a primary rationale for their current fiscal policy of sustained surpluses.

Figure 8: Long-term Projections for Pension Expenditures and Petroleum Revenues as a Percentage of GDP in Norway



Source: Statistics Norway and Norwegian Ministry of Finance.

In the mid-1990s, Norwegian decisionmakers reached a broad consensus on the need to save projected surpluses to pay for future budget needs and to help increase long-term economic growth. Surpluses were projected to result from increased oil revenues and a strengthening economy. To ensure that surpluses were saved, the government created the Government Petroleum Fund, in which surpluses were to be deposited to help pay for future pension costs.¹ The fund's assets are invested in foreign stocks and bonds to help reduce inflation and upward pressure on the exchange rate. Low inflation and a stable exchange rate help to keep Norway's exports competitive with other countries. If Norway allowed excess petroleum revenues to remain in the domestic economy, it could result in higher levels of inflation and an appreciation in the value of its currency. As a result, non-oil industries would become less competitive over time as the price of their goods and services would rise relative to foreign competitors. This is a major concern to policymakers because Norway projects that petroleum output will decline early in the 21st century, and Norway will have to rely

¹The government decided not to use surpluses to pay off debt. It wished to keep a domestic debt market active in case it needed to increase borrowing, and by paying off debt it would keep petroleum money in the domestic economy, possibly adding to inflationary pressures.

more on its non-oil industries to generate economic growth. If those industries lose their competitiveness now, it could have a negative impact on long-term economic growth when the petroleum industry declines. Consequently, policymakers in Norway have come to view surpluses as critical to the long-term fiscal and economic health of the country. The Government Petroleum Fund has become a symbol of the importance of saving for future needs.

The ability of the government to maintain fiscal discipline during a period of surplus has come under increasing pressure. Fiscal policy stance remained tight through 1997, with the cyclically adjusted deficit, excluding oil, declining from over 7 percent of GDP to less than 3 percent—a major fiscal tightening by international standards.² Following the 1997 elections, a weak minority coalition took over the government, and proposed to use a portion of the surpluses to increase spending on pensions and family allowances in its first budget. A sharp decline in oil revenues in 1998 led to a sharp decline in the budget surplus, including oil revenues, from about 7 percent of GDP to about 4 percent of GDP. Financial markets became concerned over the relatively easy stance of fiscal policy, resulting in strong downward pressure on Norway's currency. Furthermore, a tight labor market has led to increased inflationary pressures. The government remains committed to maintaining surpluses, but it may be difficult for a weak minority coalition government to maintain fiscal discipline in light of the pressures that have emerged since 1997.

**New Zealand and Sweden Aim
for Surpluses to Reduce Debt
Burden and Maintain Investor
Confidence**

Both New Zealand and Sweden have set sustained surpluses as their primary fiscal goal in order to reduce debt burden, which increased greatly during the previous deficit period. New Zealand's general government gross debt reached a peak of nearly 65 percent of GDP in 1992, while Sweden's debt climbed to over 80 percent of GDP in 1994. Surplus goals were also adopted to regain investor confidence after a loss of confidence in the early 1990s led to a credit downgrade and/or currency devaluation.

²Norway's budget is in deficit if the effects of oil revenues' economic growth are excluded.

As each country neared a budget surplus, decisionmakers decided to set sustained surpluses as their main fiscal objective. In New Zealand, this goal took the form of an explicit goal to reduce debt burden by running surpluses. In 1994, New Zealand enacted the Fiscal Responsibility Act (FRA) which put in place a framework to guide fiscal decision-making. FRA was enacted in part to address concerns that a recently enacted electoral reform could weaken political resolve to sustain fiscal discipline.³ FRA requires the government to set a prudent debt level, and to attempt to run budget surpluses until the goal is achieved. A debt target provides an additional measure of fiscal health and provides justification for continued surpluses.

FRA has played a critical role in New Zealand's ability to sustain fiscal discipline during its current period of budget surplus. Initially, in 1994, the government set a goal to reduce net debt to between 20 and 30 percent of GDP from over 40 percent. The government committed the entire budget surplus to debt reduction, but promised to cut taxes once the debt target was achieved. In 1996, when it became apparent that the 30 percent debt target would be achieved, the government enacted a tax cut and reset its debt target to 20 percent of GDP.

FRA has continued to play a critical role following the first election under the new electoral system. Following the 1996 election, a coalition government formed for the first time in many years. The minority partner in the coalition government was a strong advocate of new social spending, while the larger National party, which had held the previous majority government, was a major advocate of continued debt reduction and tax cuts. Nonetheless, under their coalition agreement the new government set continued surpluses and debt reduction as its overall fiscal policy. As a compromise, they agreed to delay planned tax cuts 1 year and implement a spending package while still allowing for continued surpluses. In 1998, the minority partner left the coalition government and the National party continued as a minority government. The government has retained the previously agreed to debt target to justify continued fiscal discipline. In the fall of 1998, when budget forecasts showed that the budget would go into a

³In 1996, New Zealand's electoral system was changed from a first-past-the-post system, in which the candidate with the most votes won the seat, to a mixed member proportional (MMP) system, in which seats were awarded to political parties in rough proportion to their share of the popular vote. MMP was put in place to address concerns that smaller political parties were not adequately represented in Parliament. As a result, the likelihood for coalition and/or minority governments increased greatly.

deficit, largely as a result of the Asian economic crisis, the government enacted a package of spending cuts and scaled back the previously promised spending increases to sustain surplus. Consequently, the government is projecting rough balance in the operating budget for fiscal year 1999-2000 and operating surpluses starting in fiscal year 2000-2001.

Similarly, the Swedish government has also set a goal of sustained surpluses to reduce debt and to maintain investor confidence. Of the case study countries, Sweden experienced the most severe economic downturn and the largest budget deficit during the 1990s. In reaction, the government ended its fixed exchange rate policy, enacted a large deficit reduction package, and reformed the budget process to better support fiscal discipline, putting in place multi-year expenditure limits for the first time. In 1997, when it became apparent that the budget was nearing balance, the government set a goal for surpluses of 2 percent of GDP in order to help retain investor confidence in its policies and to ensure continued progress toward debt reduction.

By setting an explicit goal and keeping to expenditure limits, the Swedish government has been able to maintain fiscal discipline during the early stages of its current surplus period. Specifically, the government established expenditure limits for 1998 that would allow it to gradually achieve its surplus goal. However, due to continued strong economic growth and other technical factors, Sweden achieved its surpluses earlier than expected.⁴ As larger than expected surpluses are projected, the government has reiterated its commitment to the previously agreed to expenditure limits. At the same time, the government has been able to increase spending somewhat because of the way the expenditure ceilings work. Under Sweden's new budget process all open-ended appropriations, mostly to entitlement programs, were abolished, making all expenditures subject to annual reviews. To provide a buffer against forecasting errors in these programs, the government built a "budget margin" into the expenditure limits. Thus, to the extent economic and budget forecasts turn out to be accurate or better than expected, the government can increase spending up to the amounts allowed under the expenditure ceilings.⁵ Since the expenditure ceilings have been in place, the economy has outperformed the forecasts, freeing up additional room for spending.

In 1999, actual spending was projected to breach the expenditure caps. The government reiterated its commitment to the expenditure caps and proposed cutting spending by about 1 percent to stay within the caps, including cuts to labor market programs, agriculture, and health care. Due to concerns over its international competitiveness—Sweden has among the highest overall tax levels among OECD countries—the government has also proposed a package of tax cuts aimed mostly at low and medium income workers.

Three Countries Aim for Balance Upon Achieving a Budget Surplus

Upon achieving surplus, Australia, Canada, and the United Kingdom each set a fiscal policy goal of balance. However, each country has developed a cautious fiscal strategy, which has resulted in them achieving small surpluses in the near term. The budget process has continued to play a key

⁴For example, in 1998, the government incorporated the National Pension Fund's real estate holdings, which resulted in an upward adjustment of the financial balance due to government accounting rules.

⁵If budget or economic forecasts turn out to be overly optimistic, then the government would presumably be forced to take action to stay within expenditure limits by cutting spending. There is some additional flexibility to borrow against future year expenditures.

Australia Aims to Maintain National Saving

role in each country's ability to limit spending and tax actions following the arrival of surpluses. In general, their spending and tax actions have been taken to address perceived needs arising from their previous deficit reduction periods.

Australian policymakers have focused on the need to increase national saving and long-term economic growth to guide their fiscal policy decisions. The government was particularly concerned that continued deficits could act to reduce national saving, which had fallen in the early 1990s by more than 5 percentage points below the average of the prior three decades. This is of major concern to policymakers because Australia has had to rely on foreign sources of capital to finance private investment. Concerns arose about Australia's prospects for long-term economic growth if it had to depend on foreign sources to make up the saving-investment gap. As the fall in national saving closely tracked increased public sector borrowing, policymakers committed to fiscal policies aimed at restoring national saving by reducing government borrowing. With the government running balanced budgets instead of deficits, more resources would be available for private sector investment.

Consequently, the current government in Australia has set a fiscal goal of balanced budgets over the economic cycle to ensure that, overtime, the Commonwealth general government sector "makes no call" on national saving, and therefore does not detract from national saving.⁶ For example, one of the justifications for establishing mandatory private pensions was to increase national saving.⁷ Currently, the government is aiming for budget surpluses for the medium term to coincide with a strong economy.

Since 1996, the "Charter of Budget Honesty" (the Charter) has played a critical role in framing Australia's fiscal policy stance. The Charter set out principles for the conduct of sound fiscal policy and put in place

⁶The government took "balance over the cycle" to mean that it would run surpluses during periods of economic growth to increase budgetary flexibility and allow the government to better respond to future economic shocks.

⁷In 1992, the Commonwealth government passed the Superannuation Guarantee Act making it mandatory for employers to offer retirement benefits, in the form of employer-funded pension programs, to their employees. Under the Act, employers make contributions to individual pension accounts of the employees' choosing. By 1996, approximately 89 percent of public and private sector employees were covered by superannuation, with the remaining 11 percent of the work force falling below the income threshold where superannuation started to apply.

institutional arrangements designed to improve discipline, transparency, and accountability in the formulation of fiscal policy. Specifically, the Charter established the following five principles for sound fiscal management: (1) to maintain prudent levels of debt, (2) to ensure that fiscal policy contributes to national saving and moderates economic fluctuations, (3) to pursue a policy of stable and predictable tax burdens, (4) to maintain the integrity of the tax system, and (5) to ensure that policy decisions consider impacts on future generations. The framework of the Charter allows flexibility for the government to define its medium-term fiscal strategy and short-term fiscal goals in such a way as to fulfill these principles.

In fiscal year 1997-98, Australia achieved a small budget surplus, and, with the fiscal year 1999-2000 budget, the government forecasts surpluses for the next 4 years.⁸ The government's medium-term fiscal strategy, developed as required by the Charter, is to balance the budget over the cycle, which means a short-term goal of running surpluses during the projected period of expansion. Also, the government currently has a goal to eliminate net debt by fiscal year 2002-03 from its 1998-99 level of about 11 percent of GDP.

Within this goal of surpluses for the short term, the government has made room for new selected spending increases and selective tax cuts. The fiscal year 1998-99 budget proposed spending initiatives totaling nearly A\$10 billion through fiscal year 2001-02, with a large portion dedicated to health care. The government has also decided to use a portion of its projected surpluses to help finance a major tax reform, which was passed in 1999. The tax reform package included the introduction of a national goods and services tax (GST) along with a reduction in income tax rates for individuals. A GST has been proposed several times in Australia's recent history but has failed to pass due to concerns over its regressiveness. However, the government was able to pass the GST in 1999 due, at least in part, to the availability of budget surpluses that could be used to pay for income tax rate cuts used to offset the impact of the GST.

⁸Beginning in 1996 the Australian measurement of the surplus/deficit changed from a cash basis to an "underlying" balance basis, which excludes the net effects of advances, such as loans, and equity transactions, such as sales and purchases of capital assets, from the calculation of surplus/deficit. If a cash measurement is used, Australia achieved a small surplus in fiscal year 1996-97.

Canada Aims for "Balance or Better"

Upon achieving a surplus, Canada set as its fiscal goal to achieve "balance or better" and has kept its "prudent" budget practices in place to better ensure that it meets its goal. These "prudent" budget practices were put in place in support of the government's effort to eliminate deficits and include a shortened forecast period of 2 years, the use of conservative economic estimates, and a contingency fund to be used for unforeseen events or debt reduction. The effect of these practices has been that Canada has met or exceeded its fiscal goals. During a surplus period, the effect has been to limit the ability of the government to spend surpluses until they materialize. Thus, Canada has adopted a cautious allocation strategy, waiting until additional resources are nearly certain before introducing small-scale tax cuts and spending increases.

The Finance Department uses assumptions for interest rates, and sometimes economic growth, that are intentionally more conservative than private sector forecasts. This cautious forecasting policy has been in place since 1994 and was based on a recommendation from a panel of economists convened in late 1993 to advise the government on fiscal and economic issues. The panel's recommendation was underscored by a private sector analysis that found that the government's economic assumptions in the 1980s and early 1990s tended to be overly optimistic. Under the current government's cautious approach, the Finance Department's economic assumptions have often been more pessimistic than actual outcomes.

The contingency reserve is an annual amount that is built into projected spending, but is not allocated to any specific program. It is an accounting mechanism used to supplement the government's cautious forecasting policy, rather than an actual cash fund. Under the current government, this reserve is not available to fund new initiatives. Instead, it serves solely as a buffer against unanticipated developments, such as an adverse change in the economy. If the government's budget projections are on target (or overly pessimistic), the reserve acts to reduce the deficit or increase the surplus. For example, in fiscal year 1998-99, the government projected a balanced budget. This balanced budget estimate assumed that the CAN\$3 billion contingency reserve would need to be spent to compensate for shortfalls in the projections. If the budget forecast is exactly on target, the government will actually realize a CAN\$3 billion surplus that will be used to reduce debt. For example, in fiscal year 1998-99, the actual fiscal result was close to the target, and Canada realized a surplus of CAN\$2.9 billion, which it used to reduce debt.

The final element in the government's cautious approach is a short forecast horizon; it publishes detailed projections for only 2 years. Prior to the current government, the Finance Ministry used a 5-year budgeting time frame for setting fiscal policy and repeatedly failed to meet its deficit targets. In contrast, since fiscal year 1994-95, the current government has consistently bettered its 2-year fiscal targets. While using a short forecast period is not necessarily a more prudent approach to budgeting, the government explains that its short horizon is a response to the inherent sensitivity of longer-term forecasts to future economic developments. Another important reason for the shorter forecasts is that during a period of deficit reduction, they focus attention on making cuts today rather than delaying action until tomorrow. During a time of surplus, shorter forecasts can reduce the temptation to spend projected surpluses. On the other hand, a short-term budgeting time frame does not disclose the full long-term impact of policy decisions.

As it has entered a period of budget surpluses, the government has continued to rely on a cautious approach. Excluding the contingency reserve, the Finance Ministry does not publicly project budget surpluses. The government's current fiscal goal is, at a minimum, a balanced budget—a strategy that it refers to as “balance or better.” However, the contingency reserve implies that the actual target is a surplus of at least CAN\$3 billion, about 0.3 percent of GDP. The government has acknowledged it anticipates budget surpluses by introducing the “Debt Repayment Plan.” The plan is an explicit statement that the government's cautious approach could result in budget surpluses and that the contingency reserve would be used to reduce debt. The 1999 Budget Plan states that “the level of debt in relation to the ability to service the debt (the debt-to-GDP ratio) is still too high [at about 65 percent of GDP]—both by historical Canadian and international standards. . . . Reducing the debt-to-GDP ratio must remain a key objective of the government's fiscal policy.”⁹

While the government is committed to using a modest amount of budget surpluses for debt reduction through the contingency reserve, it also uses surplus revenues for new spending and tax cut initiatives. This strategy of dividing surpluses between debt reduction, tax cuts, and new spending was articulated during the government's 1997 reelection campaign. At that time, the government stated that it would devote 50 percent of budget surpluses

⁹ *The Budget Plan 1999*, Government of Canada, Department of Finance, February 16, 1999, p. 52.

to new spending and the other 50 percent to a combination of tax cuts and debt reduction. Analysts we interviewed stated that this allocation framework applies to surpluses over the full parliamentary term and will not necessarily be followed on a year-by-year basis.

In both the fiscal year 1998-99 and 1999-2000 budgets, the government introduced a number of new selected spending and tax initiatives. The Finance Ministry estimates that these initiatives will cost the government about CAN\$50 billion cumulatively from fiscal year 1997-98 to 2001-02. On the spending side, these initiatives have focused on health care and education. The tax changes include an increase in the amount of income that low-income earners can receive on a tax-free basis, the elimination of a 3 percent surtax, an increase in the Child Tax Benefit, and a reduction in employment insurance rates for both employers and employees.

In launching new policy initiatives, the government has adopted a philosophy that generally avoids committing resources before they materialize. Typically, the government does not introduce new spending or tax cuts until late in the fiscal year when a surplus becomes apparent. The fiscal year 1999-2000 budget explained this approach and its rationale as follows:

"Central to [the government's] planning approach is the notion that spending initiatives and tax cuts will be introduced only when the government is reasonably certain that it has the necessary resources to do so. This protects against the risk of having to make hasty, and potentially damaging, corrections to the budget plan, such as announcing tax relief one year and then having to raise taxes the following year."

In line with this cautious approach, the government has generally shied away from both large-scale spending commitments and major tax cuts. In addition, the government has enacted nonpermanent spending initiatives, showing its preference for limiting future commitments. An example is the Canada Millennium Scholarship Fund. The full cost of the fund—a nonrecurring CAN\$2.5 billion—was booked in fiscal year 1997-98, though scholarships will not be awarded until 2000.¹⁰ The government has also made many nonpermanent investments for health care, research, and education, addressing some of the areas cut back the most during the previous period of deficit reduction. This cautious strategy for allocating

¹⁰It should be noted that the Office of the Auditor General argued that this transaction should have been booked in the year it occurred, and as a result the federal surplus figure for 1997-98 was understated by CAN\$2.5 billion.

United Kingdom Aims to
Increase Investment Spending

extra resources is supported by the Finance Ministry's use of conservative economic assumptions, which tend to understate the resources available for spending.

The current government has developed a new framework for fiscal policy that reflects "lessons learned" from the United Kingdom's past experiences. The fiscal strategy emphasizes a greater focus on the structural budget, a more explicit distinction between current and capital spending, and firm multi-year spending ceilings that will not be subject to annual review. The current Labor government's fiscal strategy is guided by two rules: (1) the "golden rule," under which borrowing will not be used to finance current spending (that is, total spending excluding investment), and (2) the "sustainable investment rule," which promises to keep net public debt as a share of GDP at a "stable and prudent" level (which the government currently defines as below 40 percent). Both rules are to be applied over the economic cycle, allowing for fiscal fluctuations based on current economic conditions.

Under the "golden rule," the government is aiming for operating balance, allowing for deficit financing of capital investment. The government defines investment as "physical investment and grants in support of capital spending by the private sector."¹¹ Investment spending was significantly restrained under the previous deficit reduction efforts, and, as a result, the current government has made boosting public investment a major priority, proposing to nearly double it as a share of the economy—to 1.5 percent of GDP—over the course of the current Parliament. While investment spending is a priority, the "sustainable investment rule" is intended to ensure that financing such spending does not result in an imprudent rise in debt.

A sharper focus on the economic cycle is a general feature of the current government's policy that explicitly reflects the "lessons learned" from the past. A recent Treasury report explains the importance of taking the cycle into account:

¹¹ *Fiscal Policy: current and capital spending*, HM Treasury (United Kingdom), p. 7, footnote 2.

"Experience has shown that serious mistakes can occur if purely cyclical improvements in the public finances are treated as if they represented structural improvements, or if a structural deterioration is thought to be merely a cyclical effect. The Government therefore pays particular attention to cyclically-adjusted indicators of the public sector accounts."¹²

As a result of the government's rules, its fiscal policy allows for small deficits to be used to finance investment spending, provided that overall debt burden is kept at a stable and prudent level. Despite this allowance for small deficits, the Treasury estimates that the budget registered a surplus of 0.1 percent of GDP for public sector net borrowing in fiscal year 1998-99. Using the government's "current budget" measure, which excludes investment, the fiscal year 1999-2000 budget estimated that there would be a surplus of 4.1 percent of GDP for fiscal year 1998-99 and projected surpluses on the current budget every fiscal year until 2003-04.

¹² *Stability and Investment for the Long Term: The Economic and Fiscal Strategy Report 1998*, HM Treasury (United Kingdom), June 1998, p. 45.

Countries Have Taken Actions to Address Long-Term Pressures

Over the past two decades, the case study countries have taken actions that address long-term fiscal pressures expected to arise from aging populations. In Norway's case, long-term pressures were a major factor leading the government to decide that surpluses were needed to ensure the long-term sustainability of its policies. For other countries, programmatic reforms aimed at addressing long-term pressures enacted prior to the arrival of surpluses resulted in increased fiscal flexibility during a period of surplus. Over the last two decades, four countries--Australia, Canada, Sweden, and the United Kingdom--enacted major pension reforms that have reduced long-term budgetary pressures and put their pension systems on a more sustainable path. Consequently, as these countries have entered a period of surpluses, long-term budgetary pressures due to increasing pension costs have not emerged as a major focus of political debates.

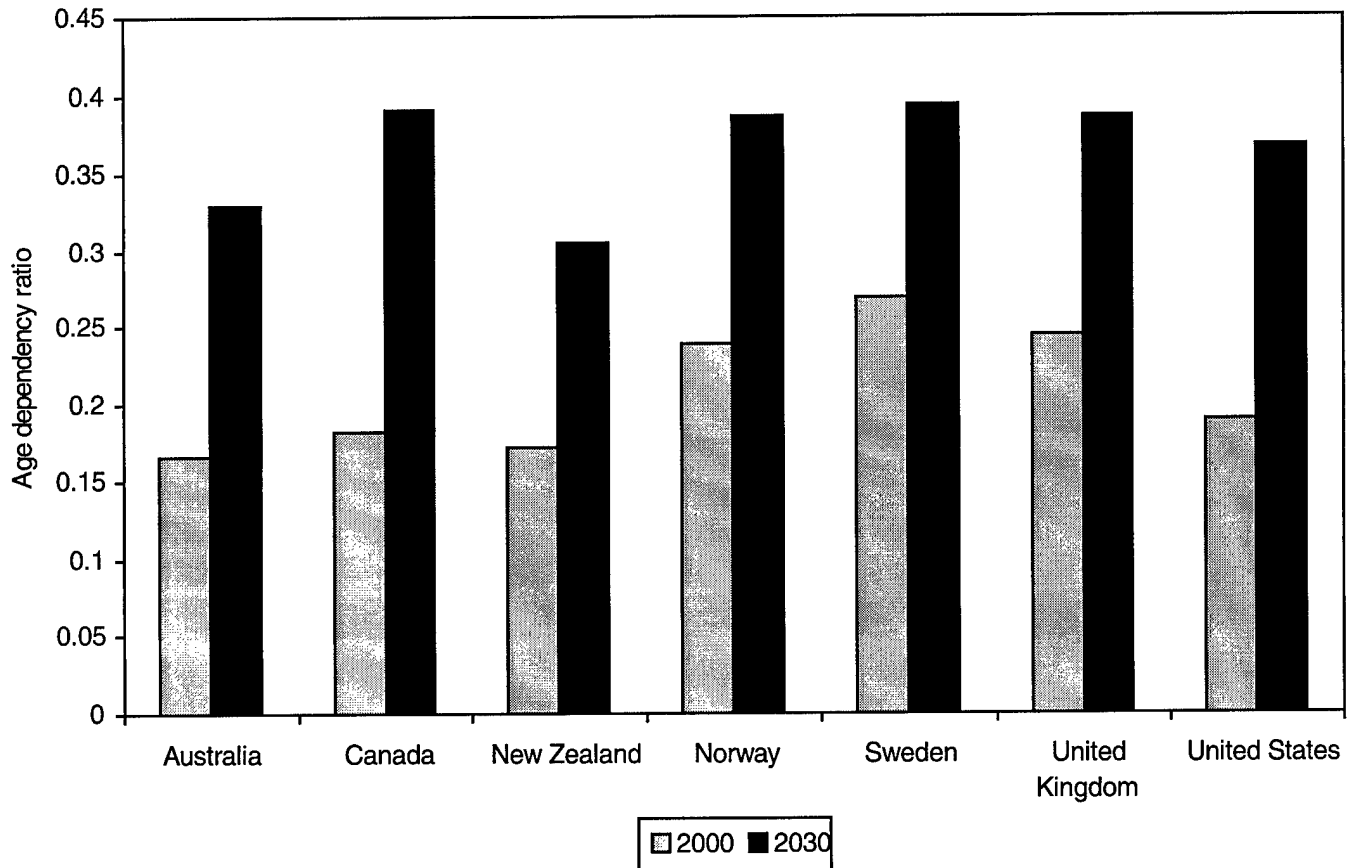
By achieving budget surpluses and reducing debt, these countries have taken a step toward improving their long-term fiscal and economic health and enhancing future budget flexibility. Budget surpluses increase national saving, which can lead to increased investment and productivity, thereby increasing potential future economic output and living standards. By reducing debt, budget surpluses also reduce the government's interest costs, freeing resources to be spent on other priorities. Furthermore, lower levels of debt can improve a nation's capacity to borrow and meet future budgetary needs.

Most Countries Face Increasing Costs Due to an Aging Population

Like the United States, most countries in our study face impending challenges arising from an aging population. While demographic trends differ among the countries, all are projecting an increase in the ratio of retirees to working age population. If current spending patterns continue, increased spending on pensions and health care threatens to crowd out spending on other important public goods and services.

Each of the case study countries is projecting an increase in the aging population relative to the working age population. (See figure 9.) In about 10 years, the baby boom generation will start to retire, and the number of retirees will rise faster than in the past. Increased life expectancy will also contribute to the aging pressure, as the number of years spent in retirement increases. The number of people in the working population will also shrink as a percentage of the population, placing increased pressure on the fiscal system. In Canada for example, the ratio of people aged 65 and over to those in the working age population is expected to more than double between 2000 and 2030.

Figure 9: Ratio of Population Aged 65 and Over to Population Aged 15-64, 2000 and 2030



Source: Data from *World Population Projections 1994*, The World Bank, Bos et al.

The aging population is expected to give rise to growing demand for pension and health care services. The demand for public pensions alone can be a substantial strain on the budgets, caused by annual public pension costs that, absent any policy changes, are expected in some countries to double as a percentage of GDP by 2030. (See table 2.) For example, annual public pension costs in Norway are projected to increase from about 7 percent in 1996 to about 15 percent in 2030. Similarly, the demand for health care is expected to increase substantially, not only from an aging population but also from improved technology and the resulting greater expectations placed on the health system. Several countries have taken

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steps to address these pressures, either by setting aside budget surpluses as Norway has done or by enacting pension reforms.

Table 2: Projected Growth in Annual Public Pension Expenditures as a Percentage of GDP, 1995-2030

	1995	2030	Description of public pension system
Australia	3.2	4.1	Flat-rate, means-tested benefits financed from general fund revenue. Also includes service pension for veterans.
Canada	4.4	7.5	Near-universal, non-contributory benefits financed from general fund revenues and a compulsory earnings-related public pension.
New Zealand	5.0	9.0	Flat-rate benefits financed from general fund revenues.
Norway	7.0	15.0	Flat-rate, universal benefits and additional benefits based on annual earnings and years at work financed by payroll taxes and general fund revenues. Includes disability pensions.
Sweden	11.8	15.0	Flat-rate, minimum benefits for all residents meeting residency or work requirements and a supplementary pension based on income. Also includes government housing supplements and a system of partial pension for those between 61 and 64 years of age.
United Kingdom	4.2	4.7	Flat-rate, basic benefits supplemented by an earnings-related pension. Employees are provided tax incentives to move from the public earnings-related pension plan into private plans. Also includes means-tested assistance for low-income retirees.
United States	4.8	5.9	The Old-Age, Survivors and Disability Insurance Program provides monthly payments based on annual earnings to beneficiaries. The program is financed from payroll taxes.

Note: In Australia, the public pension system is supplemented by a mandatory private pension scheme funded from employer contributions. In Sweden, in 1998 the Parliament passed legislation to comprehensively reform the pension system from a pay-as-you-go, defined-benefit system to a pay-as-you-go, defined contribution system with mandatory individual accounts. Pension expenditure data for Sweden does not reflect the reform.

Sources: Data from case study countries; David Stanton and Peter Whiteford, *Pension Systems and Policy in the APEC Economies*, 1998; Bosworth and Burtless, *Aging Societies: The Global Dimension*, 1998; Social Security Administration, *Retirement Income Security in the United Kingdom*, 1998; 1999 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

Countries Have Taken Action to Address Future Demographic Pressures

Case study countries have taken actions in recognition of the fiscal and economic pressures arising from aging populations. As discussed in chapter 2, Norway has developed a policy goal to save its current budget surpluses to address long-term pressures. In 1991, Norway established the Government Petroleum Fund, in which budget surpluses are invested in stocks and bonds to be used in the future to pay for a projected increase in pension spending.¹ Other countries have taken actions to reform their pension systems prior to the arrival of budget surpluses, allowing them to focus on other uses for their surplus.

Norway Has Set Aside Surpluses to Address Long-term Issues

Norway faces the situation of an aging population, a shrinking proportion of working age population to retirees, and a projected sharp decline in oil revenues in the future. As noted in chapter 2, pension expenditures as a share of GDP are projected to more than double by 2050, while petroleum revenues as a share of GDP are projected to fall drastically over the same period. Today, revenues from petroleum activities account for a significant share of government revenues at about 16 percent of total revenue. Norway has responded to this future pressure by establishing the Government Petroleum Fund, in which budget surpluses, which are generated from petroleum revenues, are invested outside the government to pay for future pension costs. The fund constitutes a real asset that can be drawn upon as pension costs increase in the future.

The Government Petroleum Fund is also designed to boost Norway's long-term economic growth potential. The fund is invested in foreign stocks and bonds. By purchasing foreign assets, the fund automatically reduces Norway's large current account surpluses and reduces upward pressure on Norway's exchange rate, thereby enhancing the cost competitiveness of non-oil industries with other countries. The government recognizes that in the long run, as petroleum output declines, having competitive non-oil industries will become increasingly important to maintaining economic growth.

The fund could also aid long-term growth because it provides a buffer against severe downturns. While the rationale for saving more of the

¹The Norwegian government receives a significant amount of revenue annually from its petroleum sector. To "save" these excess revenues and prevent them from overheating the economy, Norway established the Government Petroleum Fund in 1991.

surplus has been the long-term pressure caused by an aging population, fund assets are not explicitly reserved for future pension costs. Consequently, fund assets may be used to cover government deficits when necessary, eliminating the need for additional borrowing. In fact, a portion of the fund has been used to cover non-oil budget deficits.

Australia and the United Kingdom Reformed Pension Systems in the 1980s

Australia and the United Kingdom enacted major pension reforms starting in the 1980s and continuing through the 1990s. Each country enacted a tiered pension system, with a significant portion of the pension benefits accruing in private plans and the government providing basic pension benefits that are either limited or have substantially eroded in value. As more workers build up pension benefits in private plans, the government's pension obligations are projected to decrease.

While the budgetary effects are similar, Australia and the United Kingdom undertook their reforms for different reasons. The United Kingdom undertook reform as part of its deficit reduction efforts and to ensure the sustainability of its pension funds. The United Kingdom's government significantly scaled back its commitment to future retirees by changing the way the basic pension was indexed and by encouraging the movement of workers into individual pensions or employer-provided pensions.² Australia reformed its pension system as part of a wider effort to reduce real wage increases and thus avert short-term inflationary pressures, to improve the living standards of retirees, and to increase national saving. In 1986, the Australian government created a guaranteed private pension scheme for employees involved in collective bargaining where employers contribute a portion of the employees' wage into individual accounts invested in the market. In 1992, this scheme was expanded to require mandatory employer contributions to employee retirement benefits.

While these countries had different rationales for reforming their pension systems, both approached the challenge of reducing the budgetary pressure of an aging population by switching a portion of the costs away from the public sector. While spending on retirement systems will increase in both countries in the next half-century, retirement spending is projected to take up a relatively small share of GDP. This may explain why, upon

²Under the revised pension indexation formula, increases were tied solely to prices rather than the greater of price or wage increases, as was done previously.

entering a period of surpluses, these countries have focused on other issues.

Canada and Sweden Reform Public Pensions to Ensure Sustainability

Sweden and Canada both account for their pension systems separately from the rest of their budgets. Both countries have generally run annual surpluses in their plans and have used the proceeds to build up reserves.³ Consequently, discussions regarding the need to address future shortfalls in their pension systems have occurred separately from debates about deficits or surpluses.

During the mid-1990s, both countries modified their pension systems to improve their sustainability. These reforms occurred largely as a result of projections showing that they would run out of money early next century. Canada's reform calls for some benefit reductions coinciding with a gradual buildup of reserves through increased payroll taxes and higher returns on investments by allowing for a portion of fund assets to be invested in stocks and bonds for the first time. Sweden changed its benefit formula to automatically adjust for changing demographics and economic performance and set up individual accounts in which individuals can choose how to invest their fund balances.

In Canada, these pension fund surpluses will continue to be excluded from the budget surplus/deficit measure. In Sweden, due to a change in its fiscal measure in 1995, pension fund surpluses are now counted as part of the government's measure of surplus. However, pension fund surpluses will continue to be accounted for separately from central government revenues, and as a result, annual budget deliberations focus primarily on the non-pension fund portion of the budget.

Reduced Debt Levels Can Help Countries Better Deal With Long- term Pressures

By eliminating budget deficits and reducing debt, case study countries have increased their ability to respond to future fiscal pressures. Lower levels of debt can increase national saving, leading to increased investment and productivity, and ultimately increasing potential economic growth. Each case study country lowered its debt burden during the 1990s. If these countries continue to reduce debt, as is the stated goal for several

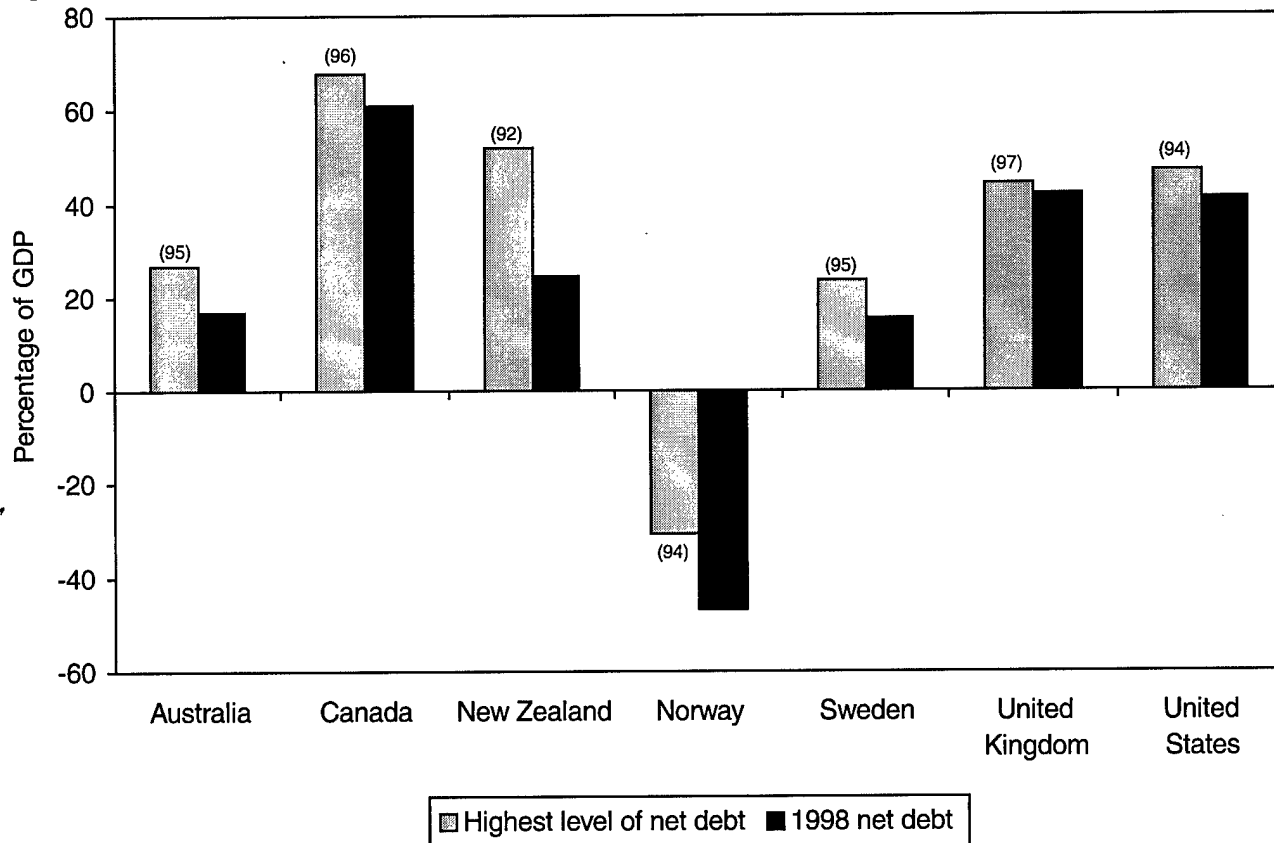
³Canada has traditionally invested its surpluses in provincial, territorial, and federal government securities. Its current reform allows for investment in stocks and bonds. In Sweden, surpluses are invested in a combination of stocks and bonds.

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countries, they can expect increased budgetary flexibility to address fiscal pressures in the future. Leaders in several countries have decided to pursue lower levels of debt to increase their ability to respond to future fiscal pressures and to improve long-term economic prospects.

As a result of improving budgets and the achievement of surpluses, case study countries have reduced their debt levels during the 1990s. (See figure 10.) New Zealand achieved the greatest improvement in debt burden during the 1990s, cutting its debt burden by more than half between 1992 and 1998. Norway also achieved great success, improving its debt burden by about 17 percent of GDP between 1994 and 1998.

Figure 10: Improvement in General Government Net Debt as a Percentage of GDP During the 1990s



Note: 1998 data for Canada, Norway, Sweden, and the United Kingdom are OECD estimates. Debt figures for New Zealand are for central government only.

Sources: *OECD Economic Outlook 65*, June 1999, and the New Zealand Treasury.

During the 1990s, policymakers have developed fiscal policies with an eye to the potential long-term benefits associated with lower levels of debt. As mentioned in chapter 2, several case study countries have pursued surpluses in an attempt to address long-term pressures, increase budgetary flexibility, and improve long-term economic growth. Canada, New Zealand, and Sweden are all attempting to reduce debt levels in order to enhance future budgetary flexibility. Norway is saving its budget surpluses to address long-term budgetary pressures. Australia views budget surpluses as a means of increasing national saving leading to higher long-term economic growth. The United Kingdom is attempting to increase

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investment spending to enhance long-term economic growth. As these countries transition to a period of projected surpluses, having a long-term outlook has played a critical role in the justification of continued fiscal discipline.

The Role of Budget Processes and Measures of Fiscal Position During Periods of Surplus

The framework for fiscal decision-making, which includes both the budget process and the way fiscal position is measured, can play a critical role in shaping fiscal policy and maintaining fiscal restraint. The budget framework can play an especially important role during a period of budget surplus when the goal of fiscal policy is not always clear and maintaining fiscal discipline can be difficult. The measure of fiscal position can be used to define a goal and to measure "success." Zero deficit is generally accepted as one such measure and a signal of the fiscal health of a country. However, during periods of surplus, other measures may play a more prominent role because they shed light on long-term fiscal health and/or the fiscal position independent of the economy's impact.

All of the countries in our study changed their budget process during the 1990s. In some cases, budget process changes were enacted to support deficit reduction efforts, while in other cases, they were enacted to help guide fiscal policy decisions. In Norway and Sweden, these changes focused on setting top-down spending and revenue targets before policy initiatives were considered, making it more difficult to increase spending and/or cut taxes. Australia, New Zealand, and the United Kingdom focused on increasing transparency by requiring the government to clearly state its fiscal goals. Canada's changes centered on using conservative budget estimates to better ensure that it would be able to meet its fiscal goals. As these countries moved into a period of budget surpluses, their budget processes have continued to play an important role in maintaining fiscal discipline and/or in setting fiscal policy.

The measures that case study countries use to assess fiscal position influence and inform decisionmaking not only during periods of deficit, but also during periods of surplus. These countries do not always focus on a cash balance figure when formulating fiscal policy. For example, some countries focus on debt burden or the structural budget position, which factors out the economy's impact on the budget. In periods of surplus, these measures can provide a justification for continued fiscal discipline, whereas focusing solely on a cash balance may not. Some other countries do not include annual surpluses from public pension funds in their primary measure of fiscal position, removing these funds from any debate about how to use surpluses.

Budget Process Changes Play a Critical Role During Period of Surplus

All the case study countries changed their budget processes during the 1990s. In some cases, budget process changes were enacted to support deficit reduction efforts, while in other cases, they were enacted to help guide fiscal policy decisions. These reforms varied in design, but all strove to make it more difficult to increase spending and/or to cut taxes. In general, the reforms took an approach where (1) overall expenditure limits were agreed upon before budget details were worked out, (2) transparency increased because governments were required to clearly define their fiscal goals, and (3) conservative budget estimates were used to better ensure that fiscal goals would be met. Decisionmakers and budget experts in each country cited budget process reforms as a critical component of their ability to maintain fiscal discipline and/or to set fiscal policy goals. As the case study countries have transitioned from deficit reduction to surpluses, leaders in these countries have continued to use budget processes to support fiscal constraint.

Expenditure Limits Used to Control Spending

Expenditure limits as part of a top-down approach to budgeting have played a key role in attempts to control spending, both during periods of deficit and surplus. Under this approach, decisionmakers agree on overall spending limits prior to making specific decisions on policy initiatives. After reaching an agreement on spending and/or revenue levels, any new policy initiative must fit within these limits.

Expenditure ceilings represented a significant change for two countries in particular. Prior to budget process reforms in the 1990s, Norway and Sweden had not previously set expenditure ceilings. In fact, the general trend in each country had been for Parliament to increase spending above the government's budget proposals, and this was perceived to be a problem in each country.

The Norwegian Parliament reformed its budget process in 1997 to show its continued support for fiscal discipline and in reaction to past spending increases. For the first time, the Parliament adopted a top-down approach to budgeting, setting aggregate revenue and expenditure ceilings. Under the old procedure there was no agreement on an overall expenditure and revenue limit at the beginning of the budget process, and the final budget represented the aggregate of individual spending decisions. As a result, the previous budget process often led to Parliament increasing spending above the government's proposed levels. Under the new budget process, Parliament agrees on an overall fixed budget ceiling and ceilings for

23 spending and 2 income areas at the beginning of the budget process. All spending and revenue proposals must fit within these ceilings.

Sweden enacted a comprehensive budget process reform in the mid-1990s in reaction to several studies which found its budget process to be among the weakest in Europe in its ability to control spending and react to large budget deficits. Under this reform, Parliament is required to pass an aggregate expenditure ceiling, and expenditure ceilings covering both discretionary and mandatory programs for a 3-year period. Once enacted, the expenditure ceilings are fixed and generally cannot be changed. Parliament passes a new aggregate expenditure limit every year for the third year only.

Sweden's budget process reform has had a significant impact on fiscal policy during the current period of projected surpluses. As Sweden entered the current period of projected surpluses, the government has remained committed to the previously agreed-to expenditure ceilings. As a result of its commitment, the government has proposed spending cuts totaling nearly 17 billion kronor in fiscal years 1999 and 2000 to remain under the expenditure ceilings. This is much different than in the past when Sweden found it difficult to maintain fiscal discipline. Also, the expenditure ceilings have changed the focus of Sweden's debate. Because the government remains committed to the expenditure ceilings, the surplus debate has so far focused mainly on the need to reduce debt or cut taxes. As a result the current government has proposed a broad-based income tax cut as part of its fiscal year 2000 budget proposal.

Countries Increased Budget Transparency by Setting Clear Fiscal Goals

Several governments in the case study countries have also attempted to increase the transparency of their budget processes by requiring clearly defined fiscal goals. These reforms require governments to set fiscal goals not only on the bottom-line fiscal position, but also for other important fiscal and economic indicators such as debt burden, national saving, and investment spending.

New Zealand was the first country to change its focus when it passed the Fiscal Responsibility Act (FRA) in 1994. Under FRA, New Zealand's decisionmakers must consider the impact of fiscal policy on such variables as debt burden and national wealth. Likewise, Australia passed the Charter of Budget Honesty Act in 1998, which requires decisionmakers to assess the budget's impact on national saving and debt burden. In 1998, the United Kingdom passed into law a requirement laying out the parameters within

which fiscal policy must be set. Based on this statute, the current government has developed a Code for Fiscal Stability, in which the government's fiscal policy stance calls for balanced budgets, on average, while allowing for borrowing only for investment.

New Zealand's Fiscal Responsibility Act

New Zealand's Fiscal Responsibility Act (FRA) introduced a new framework for fiscal decisionmaking. FRA was designed to lead to better fiscal outcomes by making policymakers consider not only the short-term impacts of decisions, but also the medium- and long-term effects. The act required that policymakers clearly define their fiscal goals and established a set of reporting requirements designed to increase the frequency and transparency of the government's fiscal reporting.

In New Zealand, the requirement that the government establish a "prudent" debt level as a fiscal goal has been critical to their ability to sustain fiscal discipline during a period of surpluses. FRA requires the government to establish a prudent debt goal and to run budget surpluses until the goal is met. This has had a significant impact on fiscal policy in New Zealand since the law was passed. In 1994, the government established a debt goal of between 20 and 30 percent of GDP, and set as its fiscal policy to run surpluses until that goal was achieved. In 1996, once the 30 percent target was achieved, the government established an even lower goal of 20 percent and passed a tax cut package. Subsequently, the government reduced its debt target to 15 percent. In the spring, summer, and fall of 1998 budget forecasts showed that the budget would return to deficit largely as a result of the Asian economic crisis. The government's reaction was to pass spending cuts to maintain surpluses and to continue to make progress toward its debt goal.

To increase public scrutiny and hold the government accountable for its performance, FRA established extensive reporting requirements. In addition to various reports, the government has to disclose all decisions that may have a material effect on the future fiscal and economic outlook. Through these extensive reporting requirements, the act attempts to ensure that departures from responsible fiscal management principles will be temporary because they will be reported to the public. Consequently, the government will be required to explain why it has not met its fiscal goals.

Australia's Charter of Budget Honesty

The Charter of Budget Honesty, which formally was passed into law in 1998, has been the framework guiding fiscal decisionmaking since the current government in Australia came to power in 1996. The Charter was

developed over concerns that the true fiscal position was not always disclosed adequately.

The Charter set out principles for the conduct of sound fiscal policy and put in place reporting requirements designed to improve discipline, transparency, and accountability in the formulation of fiscal policy. The Charter's five principles for sound fiscal management are to (1) maintain prudent levels of debt, (2) ensure that fiscal policy contributes to national saving and moderates economic fluctuations, (3) pursue a policy of stable and predictable tax burdens, (4) maintain integrity of the tax systems, and (5) ensure that policy decisions consider the impacts on future generations. The Charter, however, allows flexibility for the government to define its strategy and goals in such a way as to fulfill these principles.

To ensure improved transparency and accountability, the Charter requires extensive reporting on policies that would affect the fiscal position. Prior to or at the same time the budget is released, the government is required to issue fiscal strategy statements. An Economic and Fiscal Outlook is to be published twice each year to provide updated information so that an assessment of performance can be made. The Charter also requires that the government provide cost estimates of proposals made during the election campaign and that it publish ten days after an election is called a pre-election report to provide updated information on economic and fiscal conditions.

The Charter has been in place for only a short time, but it has helped to guide fiscal policy decisions during the current period of projected surplus. For example, the Charter requires the government to assess the impact of its fiscal policy decisions on debt level and national saving. In particular, policymakers are concerned about Australia's low rate of national saving. Consequently, the current government has established a fiscal policy goal calling for balance over the cycle—implying that it will retain surpluses during periods of strong economic growth. Under this policy, the government's actions would not reduce national saving because the government would not borrow, on average. As a result of this policy, the current government has projected that debt will be eliminated by fiscal year 2002-03, due largely to continued surpluses and proceeds from privatization.

The United Kingdom's Code for Fiscal Stability

In 1998, the United Kingdom passed into law a requirement that the government issue a "Code for Fiscal Stability." The law's purpose is to increase transparency and enhance accountability by requiring the

government to present a fiscal strategy. The statute itself is general, allowing the government wide discretion in developing a fiscal strategy. The statute establishes five principles to guide fiscal policy: transparency, stability, responsibility, fairness, and efficiency. The statute also requires the issuance of several reports detailing the government's fiscal plans.

The current government's fiscal code is guided by two rules: (1) the "golden rule," under which borrowing will not be used to finance current spending (that is, total spending excluding investment), and (2) the "sustainable investment rule," which promises to keep net public debt as a share of GDP at a "stable and prudent" level (which the government currently defines as below 40 percent). The "golden rule" is intended to ensure "prudent" control of public finances while allowing for deficit financing of capital investment. The government has made boosting public investment a major priority, proposing to double it as a share of the economy. While investment spending is a priority, the "sustainable investment rule" is intended to ensure that financing such spending does not result in an imprudent rise in debt.

Both rules are to be applied over the economic cycle, allowing for fiscal fluctuations based on current economic conditions. Taking both fiscal rules into account, the government's overall fiscal policy allows for running small budget deficits. Consequently, when it achieved a surplus in fiscal year 1998-99, the government's focus was not to sustain surpluses but to allow increased investment spending and small deficits in future years.

Canada Uses Conservative Budget Estimates to Better Ensure That It Meets Its Fiscal Goals

In 1994, a newly elected government put in place a series of "prudent" budgeting practices aimed at better ensuring that it could meet its fiscal targets. The new government felt that it had to address Canada's history of making 5-year budget projections that were never met. To better ensure that it could meet its projections, the new government put in place three main budget practices: (1) shortening budget projections from 5 years to 2, (2) using private sector forecasts and lowering them by a "prudence factor," and (3) establishing an annual contingency fund to be used for unanticipated developments and/or debt reduction.

By shortening the budget cycle from 5 years to 2, the new government felt that it could better ensure that it would meet its fiscal goals. In the past, the government's 5-year projections had proved to be overly optimistic, with the government repeatedly failing to meet its deficit targets. By using forecasts that are more conservative than private sector forecasts, the new government felt that it would eliminate criticism that it was basing its fiscal

projections on overly optimistic economic assumptions. The government took the further step of lowering these private sector forecasts by a "prudence factor," such as raising long-term interest rate projections by $\frac{1}{2}$ of one percent. Finally, the government put in place a contingency reserve that contains CAN\$3 billion annually, about 2 percent of total spending, to be used for emergencies and/or debt reduction. By putting in place a contingency reserve, the government felt that it would be able to pay for unforeseen events, better ensuring that it would meet its fiscal goals.

As Canada enters a period of small surpluses, the effect of its budgeting practices is that it generally does not spend surpluses until they are about to materialize. The size of surpluses available to be spent appear small because the government's budget forecasts are for only 2 years and are based on economic forecasts that are more conservative than private sector consensus estimates. To the extent that the economy performs better than expected, then funds become available for new policy initiatives during the fiscal year. This was the case in 1998 when surpluses developed during the year. Toward the end of the fiscal year, the government enacted several initiatives that used up those surpluses. The contingency fund, in practice, has ensured that some moderate debt reduction also occurs during a period of surplus. Under the current government, the contingency reserve is not available to fund new initiatives, thereby ensuring that some debt reduction takes place if budget forecasts are on target.

The Role of Measures of Fiscal Position During Periods of Surplus

The measures that case study countries use to assess fiscal position influence and inform decisionmaking not only during periods of deficit but also during periods of surplus. These countries do not always focus on a year-end cash balance figure when formulating fiscal policy. For example, some countries focus on debt burden, the structural budget position which factors out the economy's impact on the budget, or operating balance which is an accrual-based measure. In periods of surplus, these measures can provide a justification for continued fiscal discipline, whereas focusing solely on a cash-based measure may not. Finally, some other countries do not include annual surpluses from public pension funds in their primary measure of fiscal position, removing them from any debate about how to use surpluses.

**The Use of Debt Burden as
an Indicator of Fiscal Health**

Several case study countries use debt as an additional indicator of fiscal health and strive to reduce debt as a share of the economy. As they have entered a period of surplus, goals for reduced debt have provided justification for continued attempts to maintain fiscal discipline. New Zealand, Australia, and Sweden in particular have focused on reducing debt burden as a fiscal policy goal and as a justification for attempting to run continued surpluses.

**Accounting for the
Economy's Effects on the
Budget**

Several case study countries have set fiscal goals that take into account the economy's impact on the budget. For example, Norway's government routinely uses a structural measure of fiscal position when formulating fiscal policy. Norway's structural measure, which excludes the cyclical effects of the economy, petroleum revenues, and interest expenditures, is the key measure used to set fiscal policy. Norway's government uses this measure to assess if its overall fiscal policy is contributing to or detracting from economic growth. The government then attempts to use fiscal policy to stabilize the economy by increasing spending or cutting taxes during slowdowns to increase growth or doing the opposite during periods of inflationary growth.

Other governments have also set fiscal goals that take into account the economy's effects on fiscal position but have chosen not to employ structural measures of fiscal position when setting fiscal policy. For example, Australia's current fiscal policy calls for balance, on average, over the economic cycle. However, Australia's government does not forecast its structural budget position. It concedes in its budgets that it is very difficult to project structural position, so it does not make such projections. Likewise, Sweden aims for surpluses of 2 percent of GDP, on average over the economic cycle. However, Sweden currently does not use a structural measure of fiscal position when setting fiscal policy.

Accrual-based Budgeting

New Zealand has adopted an accrual budgeting framework, which uses an accrual-based measure—the operating balance—as a primary measure of deficit/surplus. In general, a cash-based system recognizes a cost when the cash outlay occurs, while an accrual-based system recognizes a cost in the period the resource is consumed. Consequently, the key difference between New Zealand's operating balance and the traditional cash balance relates to the period in which revenues and expenses are recorded. This difference can vary in magnitude and direction. For example, under the

previous cash system, leave liability would be recognized when a staff member left a government organization and was paid for the cost of the leave balance. Under the accrual system, the government records an expense as the leave is earned, and recognizes a year-end liability for leave earned but not taken. Financing capital projects affects the budget measure in the opposite way. Under a cash measure, capital projects were recorded when cash was disbursed. Under accrual-based measurement, capital items are recorded in the budget over the expected life of the project, thus reducing the initial budgetary impact. Consequently, the net effect of using an accrual-based measure instead of a cash-based measure depends on the specific government activities undertaken in any given year.

In addition to the operating balance, decisionmakers focus on the balance sheet—assets, liabilities, and net worth—when making fiscal decisions because they feel it provides an indication of the long-term sustainability of government programs. According to officials we met with, the balance sheet has had an impact on fiscal decisionmaking by making policymakers more aware of some long-term liabilities that were not addressed previously. For example, the recognition of a large unfunded liability in the accident insurance program was cited as a key factor in the decision to increase insurance premiums to fully fund the program. While these decisions may not have had a large immediate impact on the current fiscal balance, they contributed to programmatic changes, which have improved New Zealand's long-term fiscal health. However, it is important to note that New Zealand does not include the commitments of its social security system in its accrual-based measures.¹

Excluding Pension Fund Surpluses From Budget Debates

Two case study countries do not include the annual balances of their public pension funds in the central government's measure of fiscal position. Both Canada and Sweden account for their public pension funds separately from the general fund. The funds' assets are invested in stocks and bonds and are not available to the general fund. As a result, pension fund surpluses are not part of budget debates in Canada or Sweden. Debates regarding the need to increase pension fund assets to meet future obligations have generally occurred apart from budget debates. Both countries enacted pension reforms during the 1990s aimed at increasing the sustainability of

¹The social security commitment is not considered to be a liability under New Zealand's accounting standards.

Chapter 4
The Role of Budget Processes and Measures
of Fiscal Position During Periods of Surplus

the system as it became clear that their funds would run out of money early in the next century.

Implications

Budget surpluses reflect both the success of past deficit reduction efforts and an opportunity to address pressing needs. As a country transitions from a period of deficit reduction into a period of surpluses, it is a good time to revisit fiscal goals to determine how best to use surpluses. While balancing the budget has been the clear and generally accepted fiscal goal for many years in the United States, the appropriate fiscal policy for an extended period of budget surpluses does not seem so obvious. As discussed in chapter 1, a balanced budget is a fiscal goal that often commands broad support, while running a budget surplus is a goal with less intuitive appeal. While economists generally agree that there are benefits to running a surplus—lower real interest rates, increased national saving, and lower levels of debt—these benefits must compete with other pressing needs. It may seem difficult to justify sustained surpluses since the benefits are diffuse and occur in the future whereas new spending and/or tax cuts have more immediate and politically compelling effects. Accordingly, there may not always be a political constituency to support sustained surpluses.

The experiences of other countries suggest it is important to develop a strategy for fiscal policy specifically tailored to a period of surplus in order to guide budgetary decisions. Several countries are seeking to sustain fiscal progress during a period of budget surpluses and have developed fiscal strategies that (1) have specific goals and targets that are justified by compelling rationales, (2) responds to long-term budget pressures, (3) is flexible enough to address pent-up demands, and (4) is supported by a strong budget process. In this chapter, we highlight some of the most promising practices and approaches of the case study countries and suggest how these could assist deliberations in the United States.

Other Countries Have Developed a Surplus Strategy

Surpluses offered the case study countries an opportunity to address fiscal and economic pressures. Surpluses can be used to address any number of national priorities with long-range benefits, such as reducing debt or reforming rapidly growing entitlement programs. However, these long-range goals must compete with calls for increased spending and/or tax cuts to address more immediate demands, which can be especially strong following a period of deficit reduction.

The experiences of the nations in our study suggest that it is possible to develop a strategy to use surpluses to address national priorities. The case study countries developed fiscal strategies for a period of surplus that addressed their own unique and compelling concerns. Fiscal caution was

the watchword in most of these nations, with three countries setting the goal of sustained surplus. Others have set a goal for balance, but with the caveat that surpluses be used to address some specific need, such as increased investment spending in the United Kingdom.

Continued fiscal restraint was reflected in specific fiscal goals that guided the use of surpluses and helped crystallize political agreement. Such goals, however, had to be justified to publics that had already experienced several years of deficit reduction—a challenge that was met by pointing to the broad and compelling national economic and fiscal challenges that needed to be addressed. The fiscal goals articulated by the nations in our study were, accordingly, justified as ways to improve their long-term fiscal and economic outlook, reduce debt burdens, maintain investor confidence, and increase the national saving rate.

While these countries have taken steps to use surpluses to address long-term national priorities, they have also allowed for a portion of their surpluses to be used for more immediate needs. As part of their strategy to maintain continued support for surpluses, the case study countries also enacted spending increases or tax cuts, which were sometimes used as a reward for continued fiscal progress. For example, New Zealand promised tax cuts once debt was reduced to 30 percent of GDP. The government devoted the entire surplus to debt reduction until it reached this target and then cut taxes as promised.

A period of surpluses also illustrates the advantages of addressing budget “drivers,” such as public pension programs, that threaten long-term budget sustainability. For example, to ensure that surpluses were saved to pay for future pension commitments, Norway established a Petroleum Fund in which budget surpluses are invested to be used in the future. The case study countries that had taken actions to address budget “drivers” years before the arrival of surplus have been able to use surpluses to address other national priorities. For example, Australia and the United Kingdom reformed their pension systems during the 1980s, placing them on a sustainable long-term path, and Canada and Sweden have taken more recent actions to reform their pension systems. As each of these countries entered a period of surplus their budget debate has focused on other national priorities. The United States has not yet engaged in fundamental reforms of our public pension and health systems. Such reforms are necessary to assure the sustainability of these important national programs and to relieve the related longer term budget pressures.

In the case study countries, the budget process has played a critical role in framing budgetary decisions and maintaining fiscal discipline during a period of surplus. For example, three countries—New Zealand, Australia, and the United Kingdom—recently enacted fiscal codes that have played a critical role in shaping fiscal policy decisions during a period of surplus. These codes require policymakers to consider the overall impact of fiscal policy on such factors as debt burden, national saving, the long-term fiscal outlook, and investment spending as part of their budget deliberation policies. In the case of New Zealand, focusing on such broad indicators has allowed it to develop a compelling rationale supporting a period of sustained surplus.

Spending targets and other budget constraints have played a critical role in supporting the surplus policies of Canada, Norway, and Sweden. In Norway, the Parliament imposed overall spending caps—something they had not used before—to control spending, which had tended to increase during previous periods of surplus. In Sweden, the government has decided to maintain expenditure limits—including limits for mandatory spending on social safety net and health programs—to show its commitment to maintaining surpluses even though surpluses have materialized sooner than forecast. Finally, Canada has decided to continue using cautious budget assumptions and a short-term forecast horizon to ensure that surpluses materialize before they can be spent.

Implications for the United States

Like the nations in our study, the United States has turned years of deficits into a surplus, but unlike most of these nations, we have not yet reached agreement on goals and targets to allocate the use of our surpluses. Over the last 15 years, fiscal policy in the United States has focused on the need to reduce—and eventually eliminate—the deficit. Fiscal constraint reinforced by budget process rules and strong economic growth have been the primary reasons for our budgetary improvement.¹ In 1997, the Congress enacted a comprehensive extension and revision of expenditure caps with

¹The United States has achieved balance using the budgetary control regime established by the Budget Enforcement Act of 1990 (BEA). Under BEA the budget is divided into two parts: (1) discretionary spending, defined as spending that stems from annual appropriations acts, and (2) direct spending, or spending that flows directly from authorizing legislation; often referred to as mandatory spending. Discretionary spending is subject to annual dollar limits, or spending caps. Mandatory spending and receipts legislation are subject to a pay-as-you-go (PAYGO) requirement that legislation enacted during a session of Congress be deficit neutral (i.e., that any mandatory spending increase or tax cut be offset).

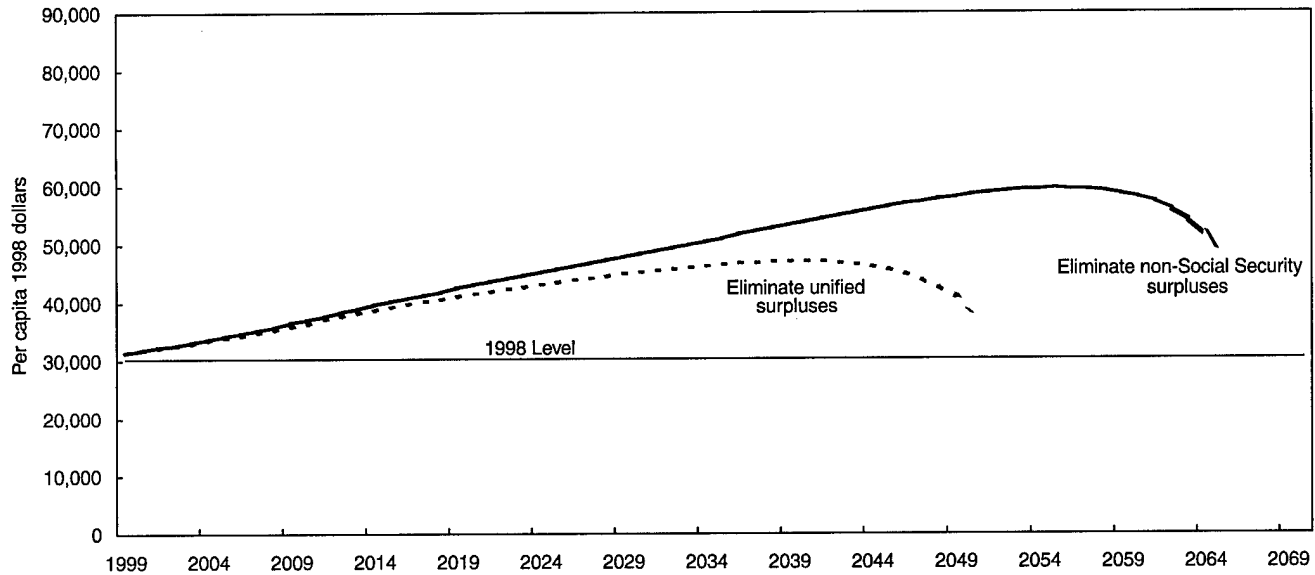
the goal of balancing the budget in 2002. However, the unified budget reached balance earlier than planned, and the Congress and the President now face the difficult situation of having to comply with tight spending caps at the same time that the budget is in surplus.

As with the nations in our study, the years of deficits have led to the accumulation of pent-up demands for federal policy actions. Although the United States is still operating under the rules established to achieve budget balance, the advent of a surplus has led to increased pressure for spending increases and/or tax cuts. The legitimacy of the restraints adopted to rescue the nation from deficits is increasingly questioned as surpluses build up.

The experiences of other nations suggest that it is possible to sustain support for continued fiscal discipline during a period of surpluses while also addressing pent-up demands. A fiscal goal anchored by a rationale that is compelling enough to make continued restraint acceptable is critical. For each country in our study the goal and the supporting rationale grew out of a unique economic experience and situation. Many in the United States have made the case for sustaining at least some portion of surpluses to help deal with our longer-term pressures. GAO's long-term model simulations illustrate the need for continued restraint: saving some of the surplus is necessary along with structural reform of retirement and health programs. Our simulations show that saving a good portion of the projected surpluses would strengthen the nation's capacity to finance the burgeoning costs of health and retirement programs prompted by the aging of our population. For instance, we have estimated that national income would be nearly \$20,000 higher per person in real terms by 2050 if the Social Security portion of the budget surplus is saved—that is, eliminate the non-Social Security surplus²—compared to a unified budget balance position. (See figure 11.) Moreover, in the United States there is widespread recognition of the need to address long-term budget drivers—Social Security and Medicare—because even if surpluses are “saved” and used to pay down debt, growth in these programs threatens to crowd out other discretionary spending. (See figure 12.)

²Assumes that permanent unspecified policy actions (i.e., spending increases and/or tax cuts) are taken through 2009 that eliminate the on-budget–non-Social Security–surpluses. Thereafter, these unspecified actions are projected through the end of the simulation period. On-budget deficits emerge in 2010, followed by unified deficits in 2019.

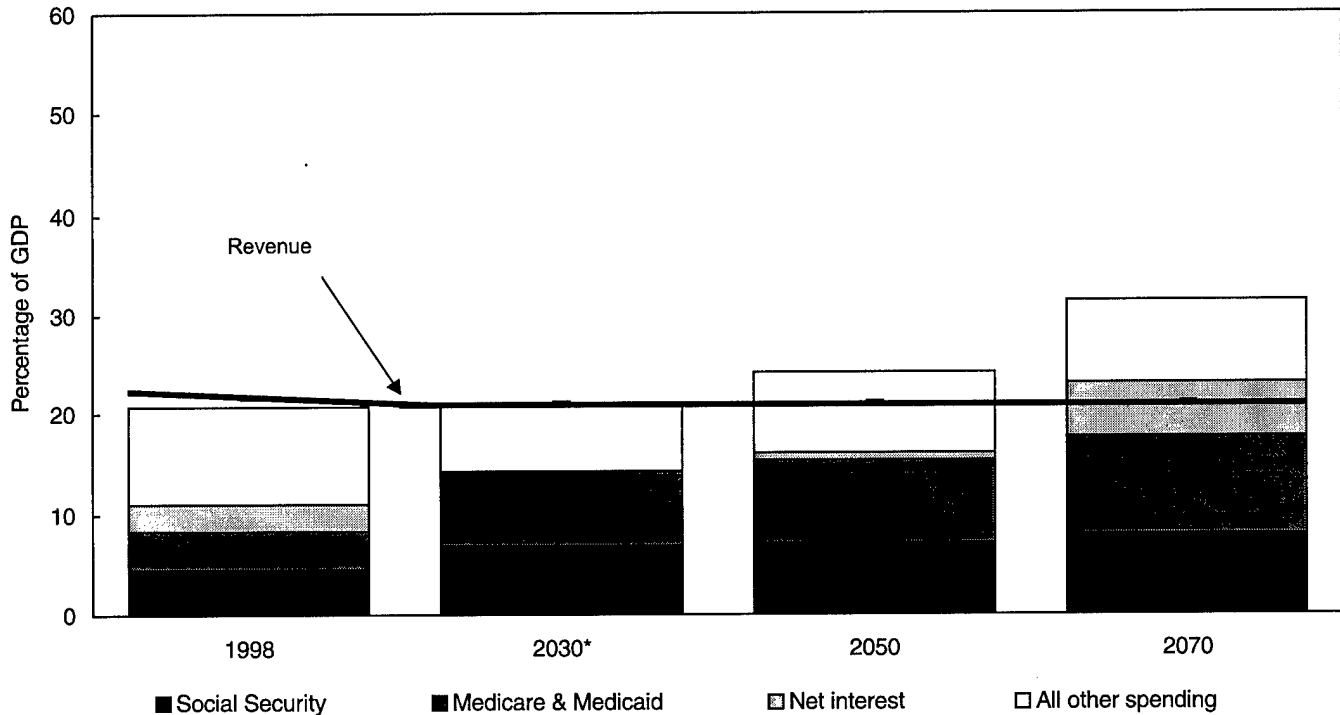
Figure 11: GDP per Capita Assuming Non-Social Security Surpluses are Eliminated vs. Unified Budget Balance



Note: The "eliminate non-Social Security surpluses" path assumes that permanent unspecified policy actions (i.e., spending increases and/or tax cuts) are taken through 2009 that eliminate the on-budget surpluses. Thereafter, these unspecified actions are projected through the end of the simulation period. On-budget deficits emerge in 2010, followed by unified deficits in 2019. The "eliminate unified surpluses" path assumes that surpluses are not retained, but that the unified budget remains in balance through 2007.

Source: GAO analysis.

Figure 12: Composition of Spending as a Share of GDP, Assuming On-budget Balance



Note: Revenue as a share of GDP falls from its actual 1998 level to CBO's 2008 implied level and is held constant at this level for the remainder of the simulation period.

*In 2030, all other spending includes offsetting interest receipts.

Source: GAO Analysis.

Moreover, there is widespread recognition in the United States of the need to address long-term budget drivers—Social Security and Medicare—because even if surpluses are “saved” and used to pay down debt, the U.S.’ fiscal path is still unsustainable over the long run. Unless policy changes are made, we could again find ourselves in a “vicious cycle” of increasing deficits and debt. Growth in Social Security and Medicare spending threatens to crowd out discretionary spending in the long run, assuming a constant tax burden. However, our budget process does not incorporate a long-term perspective, and therefore, it is not designed to address the increasing pressures in Social Security and Medicare that result from an aging population and will eventually turn budget surpluses into deficits.

Therefore, a challenge for the United States is to find a way to make the transition from a budget regime focused on eliminating the unified deficit to one that deals with allocating the surplus between long-term pressures and short-term demands. Other nations' experiences suggest that the framework for sustaining a portion of the surplus may be different than the framework for reaching budget balance. Agreement on appropriate long-term fiscal goals is important to both inform the allocation of surplus and to promote public acceptance of the choices. Overall fiscal targets could guide the more specific debate over the relative merits of different priorities—how much of the surplus to devote to reducing debt, increasing domestic discretionary or defense spending, securing existing unfunded entitlement promises, and cutting taxes. These choices could be considered within a broader context that considers tradeoffs between current consumption and saving for the future.

The design and use of fiscal targets requires care, however. U.S. experience shows that a target cannot replace agreement on the steps necessary to achieve it. In order for any fiscal policy goal to govern actions, it must be grounded in a discussion of national needs and the tradeoffs associated with reaching such a goal. In addition, selecting the appropriate measures in a time of surplus is complicated—indeed a surplus period may call for more complex measures. There is no single number like “0” in the surplus world. The debate has already begun over what might replace “0” deficit as an appropriate fiscal policy measure for the United States—and what process might be appropriate to achieve it. Several nations, for instance, have selected debt to GDP targets, with a goal of reducing debt burden over time by saving a portion of the surpluses. In our nation's setting, such targets could provide a renewed focus for fiscal policy geared to monitoring and enhancing our long-term economic and fiscal capacity to shoulder the retirement of the baby boom generation. Although it is not easy, the countries in our study sought to design a framework strong enough to guide action but flexible enough to survive when economic conditions or other factors change. In our setting, the current debate over saving the Social Security surplus may ultimately yield an agreement on both fiscal targets as well as a process for sustaining support for these targets over time.

Conclusions

Can the experiences of these nations be translated to the U.S. environment? What do their experiences say about the next steps in the U.S. debate? First, the failure to define an explicit fiscal path for the future has serious downside risks. As we have discussed in this and other reports,

"doing nothing" is not really an option—long-term pressures associated with public pension and health programs will overwhelm the budget. While the debate has begun on how to save a portion of the surplus, until the fiscal path for a period of budget surpluses is fully and clearly articulated there is a risk of losing the opportunity to enhance our long-term economic well-being. A number of the case study countries had already dealt with reform of their pension or old-age support programs; this made their task easier. This has not been done yet in the United States and so policymakers must factor the pressures associated with such programs into any new fiscal framework.

As the United States considers how to use surpluses to address our own long-term needs, the other nations' experiences suggest a framework which:

- provides transparency through the articulation and defense of fiscal policy goals;
- provides accountability for making progress toward those goals; and
- balances the need to meet selected pent-up demands with the need to address long-term budget pressures.

As the United States moves from deficit to surplus, it will be important for policymakers to reach agreement on a clearly defined and transparent fiscal policy framework that makes sense in light of both the current pressures and the long-term projections. In order for this framework to succeed in setting a broad set of principles to guide fiscal policy decisionmaking, the rationale for it must be explained and defended.

Within this new framework, clear fiscal policy goals should be articulated. As with the other countries in our study, these goals should not be rigid fixed targets to be achieved on an annual basis. Rather, they should consist of broader goals defining a future fiscal policy path for the nation. The goals can provide an accountability framework strong enough to guide annual budget targets but flexible enough to survive when economic conditions and other factors change. Without this balancing of needs, the strains on the enforcement regime become too great and the discipline to follow a glide path to achieving national goals may be weakened. In other countries these goals included reducing the burden of national debt, maintaining international investor confidence, and increasing the national saving rate. Although the prospect of a loss in international investor confidence is not as threatening to the United States as it might be for other nations, goals and measures relevant to our own long-term fiscal outlook

need to be explored. Such goals would go beyond "0" budget balance to focus on such issues as debt burden, questions of intergenerational equity, and contributions of fiscal policy to net national saving. The use of structural measures of fiscal position might help keep fiscal policy focussed on the underlying fiscal position of the federal government, excluding temporary cyclical economic trends.

The surplus presents an opportunity to address the long-term budget pressures presented by Social Security and Medicare. If we let the achievement of a budget surplus lull us into complacency about the budget, then in the middle of the 21st century, we could face daunting demographic challenges without having built the economic capacity or program/policy reforms to handle them. A new fiscal framework for a period of budget surpluses would be of great value to policymakers and to the U.S. public as the nation embarks on a period of budget surpluses. Such a framework could go a long way towards ensuring that future debate on what to do with surpluses is focussed on issues that are most critical to advancing the future economic well-being of the nation.

Developing consensus on new fiscal goals and putting in place a framework to support those goals is not easy. Other nations illustrate, however, that reaching consensus on using surpluses is possible. Our nation has made measurable sacrifices of current needs for future goals when those goals were defined in compelling enough terms. A surplus offers us with a unique opportunity to revisit the framework under which budgetary decisions are made and to address selected critical short-term needs and known long-term obligations.

Commonwealth of Australia

The Commonwealth of Australia has experienced two periods of budget surpluses since the mid-1980s, preceded by periods of deficits and deficit reduction.¹ Beginning in fiscal year 1987-88 Australia entered a 4-year period of surpluses that marked its first surpluses in more than three decades.² The surpluses were achieved through a combination of strong economic growth and deficit reduction efforts begun in 1984.³ Australia's main fiscal objective during this period of surpluses was to run balanced budgets. In accordance with this policy and the additional goal of the government to reduce outlays as a percentage of gross domestic product (GDP), the government continued to cut aggregate spending while also implementing a tax reform, which included tax cuts. Deficits reemerged in fiscal year 1991-92 primarily as a result of the 1991 recession.

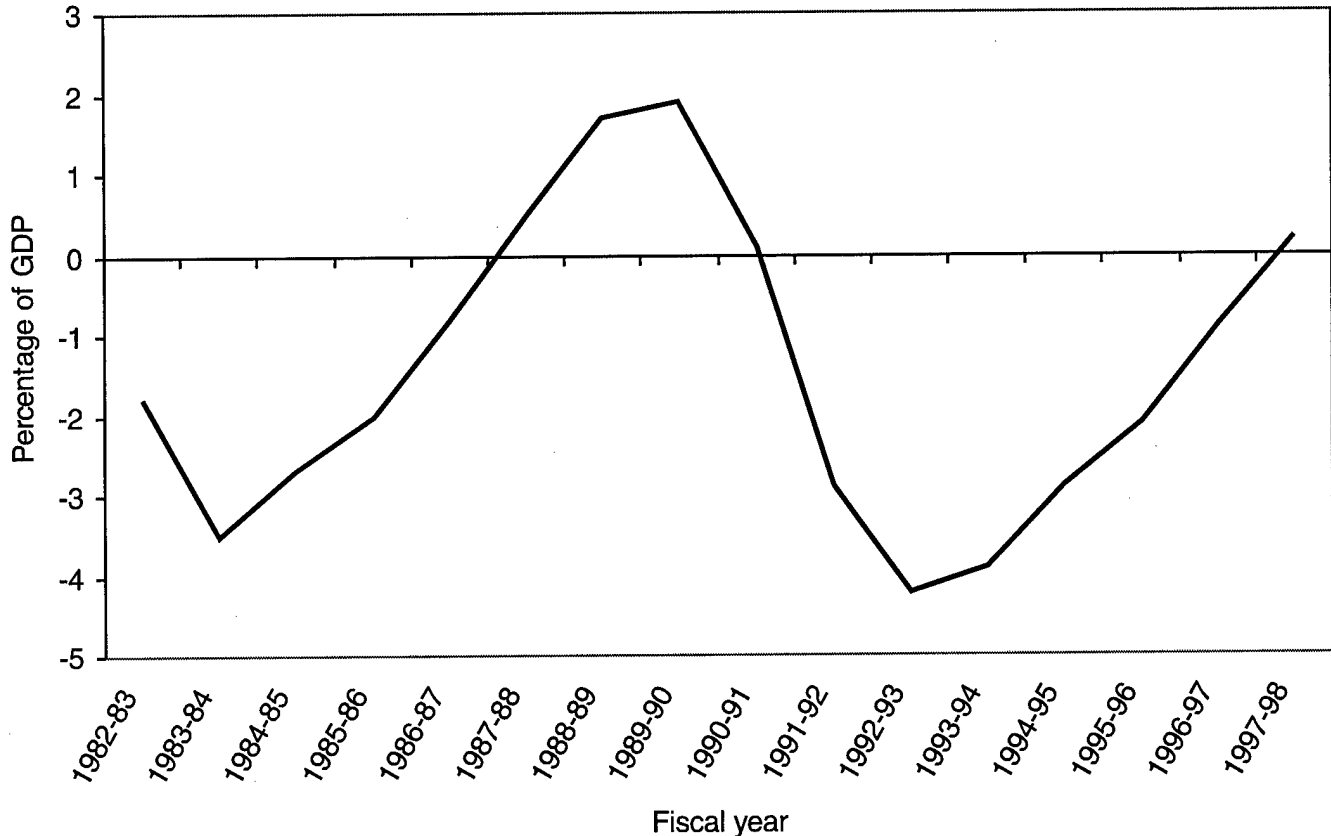
In 1996, a newly elected government embarked on a renewed deficit reduction effort and achieved a small budget surplus in fiscal year 1997-98. This government advanced a new framework for developing fiscal policy called the "Charter of Budget Honesty." The Charter laid out a set of guiding principles and reporting requirements aimed at improving fiscal performance while increasing transparency and accountability. Under this framework, the new government also established a fiscal policy aimed at achieving underlying budget balance over the economic cycle so as not to reduce national savings. In contrast to the previous surplus period when budget balance was the goal, the current government explicitly calls for running surpluses during periods of economic strength. The fiscal year 1998-99 budget forecasted surpluses totaling more than A\$23 billion for fiscal years 2000-01 and 2001-02, which were used in part to fund a tax reform package, passed in June 1999, containing tax cuts totaling A\$12 billion. Figure 13 shows the Commonwealth budget balance between fiscal years 1982-83 and 1997-98.

¹Prior to 1996 the term surplus/deficit referred to the cash balance, measured as the difference between revenue and outlays. Beginning in 1996, the measurement of the surplus/deficit changed from a cash basis to an "underlying" balance basis, which excludes the net effects of advances, such as loans, and of equity transactions, such as sales and purchases of capital assets. If a cash measurement is used, Australia achieved a small surplus of about 0.5 percent of gross domestic product in fiscal year 1996-97.

²Australia's fiscal year runs from July 1 through June 30.

³*Deficit Reduction: Experiences of Other Nations* (GAO/AIMD-95-30, December 13, 1994).

Figure 13: Commonwealth of Australia Underlying Budget Balance, 1982-83 to 1997-98



Note: The underlying balance is derived by excluding, from a cash measure of surplus/deficit, the net effects of advances, such as loans, and of equity transactions, such as sales and purchases of capital assets. If a cash measurement is used, Australia achieved a small surplus of about 0.5 percent of gross domestic product in fiscal year 1996-97.

Source: 1998-99 *Budget Strategy and Outlook*, Budget Paper No. 1.

Background

The Commonwealth of Australia is a federation composed of the national government, 6 state governments, a number of territories, and about 900 local government bodies. The legislative power at the national level is vested in the Commonwealth Parliament, made up of the House of Representatives (148 members) and the Senate (76 members—12 from each state and 2 from each of the 2 most populous territories). The party or coalition of parties with a majority in the House of Representatives forms

the government and provides the Prime Minister. Cabinet Members are generally selected from either the House or the Senate.

The two largest political parties in the Commonwealth Parliament are the Australian Labor Party and the Liberal Party of Australia. The Labor Party has traditionally represented worker and union interests while the Liberal Party has represented business and conservative constituencies. The other parties are the Australian Democrats, the National Party of Australia, and independents. The Labor Party was in office from 1983 until 1996, after which it was replaced by a Liberal-National Coalition. In the Senate, no party or coalition of parties currently has a majority.

The Commonwealth government collects more than 70 percent of the public sector revenue, but it is responsible for just over half of public sector expenditures—the remainder being transferred to state and local governments to fund additional public sector spending.⁴ However, this imbalance is being addressed by the tax reform measures to take effect in 2000-01. (See section below on tax reform.) Commonwealth budget responsibilities include national defense, immigration, postal and telecommunications services, outpatient services and pharmaceuticals, and social security.⁵ State responsibilities include most public sector spending on education, hospitals, public safety, and infrastructure. Local responsibilities include local roads and parks, libraries, and land use planning. The Commonwealth raises revenue primarily from income taxes, sales taxes, and custom and excise duties. States receive their revenue mainly from payroll, business franchise, and stamp taxes, as well as Commonwealth transfers in the form of general and specific purpose grants. Local government revenue is derived from property taxes, charges, fines, and a portion of the Commonwealth grants to the states.

The Australian Economy

Australia is a small economy that is relatively dependent on trade—its GDP is about 5 percent the size of the United States economy and exports

⁴States are limited by the Constitution in the type of tax that they can collect. In World War II, states also relinquished the power to tax income to the Commonwealth.

⁵The term "social security" refers to old-age pensions, unemployment benefits, and welfare. Old-age pension payments are funded out of the general fund, and neither employers nor employees make contributory payments. Unemployment benefits are also funded out of the general fund, and there is no separate unemployment insurance fund.

account for 15.6 percent of GDP, compared to about 9 percent for the United States in 1997.

Recent Economic History

Australia's economy grew quickly in the late 1980s, spurred by strong exports, consumption, and high business investment. However, in 1991 Australia entered a short but severe recession. The economy began to recover in late 1992 and since then Australia has experienced a period of sustained growth averaging about 4 percent per year, compared to an average slightly higher than 3 percent in the 1970s and 1980s. In the 12 months ending March 1999, GDP growth remained strong at nearly 5 percent, despite an economic crisis in much of Asia. See figure 14 for Australia's GDP growth since 1983.

Figure 14: GDP Growth in Australia, 1983 to 1998



Source: *OECD Economic Outlook 64*, January 1999.

Australia's growth in the 1990s has been accompanied by a lower rate of inflation than in the 1970s and 1980s. Despite a drop in the unemployment rate, from a peak of almost 11 percent in 1993 to 7.4 percent in May 1999, inflation has averaged an annual rate of about 2 percent since 1993. The low inflation has occurred in part due to an increased focus on sustaining a low inflation rate, with the Reserve Bank of Australia pursuing an inflation target of 2 to 3 percent over the economic cycle since fiscal year 1992-93.

However, the Australian government remains concerned about its low national saving rate and its high net foreign debt.⁶ With exports accounting for about 16 percent of GDP, the Australian economy is highly dependent on international trade for growth. Also, a large proportion of capital investment comes from abroad. National saving is crucial to economic growth because it can be used to finance domestic investment. If national saving is insufficient to fund investment, borrowing from foreign sources must finance the shortfall. The drop in national saving from an average rate of more than 22 percent of GDP the previous three decades to about 17 percent of GDP in the 1990s led to a gap between saving and demand for investment.⁷ This gap has been financed by increased borrowing from foreign sources. The outcome of this reliance on foreign capital is a high net foreign debt totaling more than 40 percent of GDP in fiscal year 1996-97—more than two-thirds of which is private sector debt.

⁶National saving consists of the private saving of households and businesses and the saving or dissaving of all levels of government. Net foreign debt measures total indebtedness of the Australian public and private sectors to foreign investors, less any investment made by the Australian public and private sectors.

⁷Gross saving is the measure of saving used here and is defined as income minus consumption. Gross saving does not subtract depreciation—the consumption of capital. Net saving, which is gross saving minus depreciation, is a better estimate of the amount of domestic resources available for increasing a nation's capital stock. However, depreciation is difficult to measure and is measured differently across countries. To facilitate cross-country comparisons, the gross saving measure is used. Using the same concept, the gross saving of the United States has fluctuated between 14 and 17 percent in recent years, down from around 20 percent in the late 1970s.

Budget Process

The government is responsible for developing the budget and presenting it to Parliament. The preparation of the budget documents is the responsibility of both the Department of the Treasury and the Department of Finance and Administration. At the beginning of the budget process, the Cabinet formulates and communicates the government's overall policy goals to the spending ministries. The Cabinet relies heavily on a subgroup known as the Expenditure Review Committee (ERC) to make decisions on which programs to fund. In general, government budgets that fund "ordinary" services are passed largely intact by the Parliament, while requests for capital and new programs are subject to Senate amendments. If the Parliament cannot pass the government's budget, it is viewed as a vote of no confidence and a new government must be formed.⁸

Under this process the bulk of budget deliberations takes place before the budget is presented publicly. The ERC defines the broad budgetary policy and sets a global budget ceiling, including budgetary savings targets and outlay targets based on a system of forward estimates.⁹ The ERC also resolves budget conflicts and decides on reductions after consulting with the appropriate Ministers. Cabinet Ministers appear before the ERC to advocate new programs or increased funding. New programs that promise to fulfill priorities set by the Cabinet are recommended to the Cabinet for new funding. Proposed spending outside of priority areas must be funded from savings in other areas.

Measuring Fiscal Position

Prior to fiscal year 1996-97, Australia's measure of federal surplus/deficit encompassed all receipts and expenditures, including privatization proceeds, other equity transactions, and net advances to other governments as well as private trading enterprises. Basically a cash measure, it captured the impact of government borrowing on credit markets and was similar to the unified budget measure in the United States.

⁸This occurred in 1975 when a refusal by the Senate to pass the funding bills for government operations resulted in a "double dissolution" of the Labor government under Prime Minister Whitlam and the sitting Parliament.

⁹Forward estimates are outlay estimates based on decisions made in the previous budget year with no future policy changes—similar to the "budget baseline" in the United States. Forward estimates are generated by the Department of Finance and Administration rather than by each individual department, as was the practice prior to fiscal year 1983-84.

In 1996, the new Coalition government changed the primary measure of budget position to an "underlying balance" measure. The underlying balance excludes the effects of advances, such as loans, and equity transactions, such as privatization proceeds. The new government felt that by excluding transactions involving the transfer or exchange of a financial asset between the public and private sectors, the measure more accurately reflects the contribution of the Commonwealth budget sector to national saving. Also, the new measure better ensures that privatization proceeds will be used for debt reduction because they do not appear as funds available for spending.

Fiscal Policy of the Mid-1980s to the 1990s Driven by the Desire to Increase National Saving and Reduce Debt

The Australian government's continued efforts—through successive administrations—to reduce its deficits and its subsequent surplus strategy have been developed largely in response to concerns over low national saving and high national debt and their impact on Australia's international competitiveness. While Australia's fall in national saving was in some part due to a decrease in private saving, it more closely tracked changes in public saving, i.e., budget balances. As a result of low national saving, investment had to be financed from foreign sources, resulting in an external debt level that was seen as too high. Low national saving and reliance on foreign capital have led to concern over Australia's ability to compete in the future.

These concerns have motivated governments to attempt to search for a solution in the public sector. Government officials felt that their ability to influence declining private saving was limited, so they concentrated on increasing public saving—i.e., reducing budget deficits. Consequently, both Labor and Coalition governments have developed fiscal policies aimed at reducing deficits in the belief that improving the government's own fiscal performance could contribute to improved national saving.

Mid-1980s: First Period of Deficit Reduction

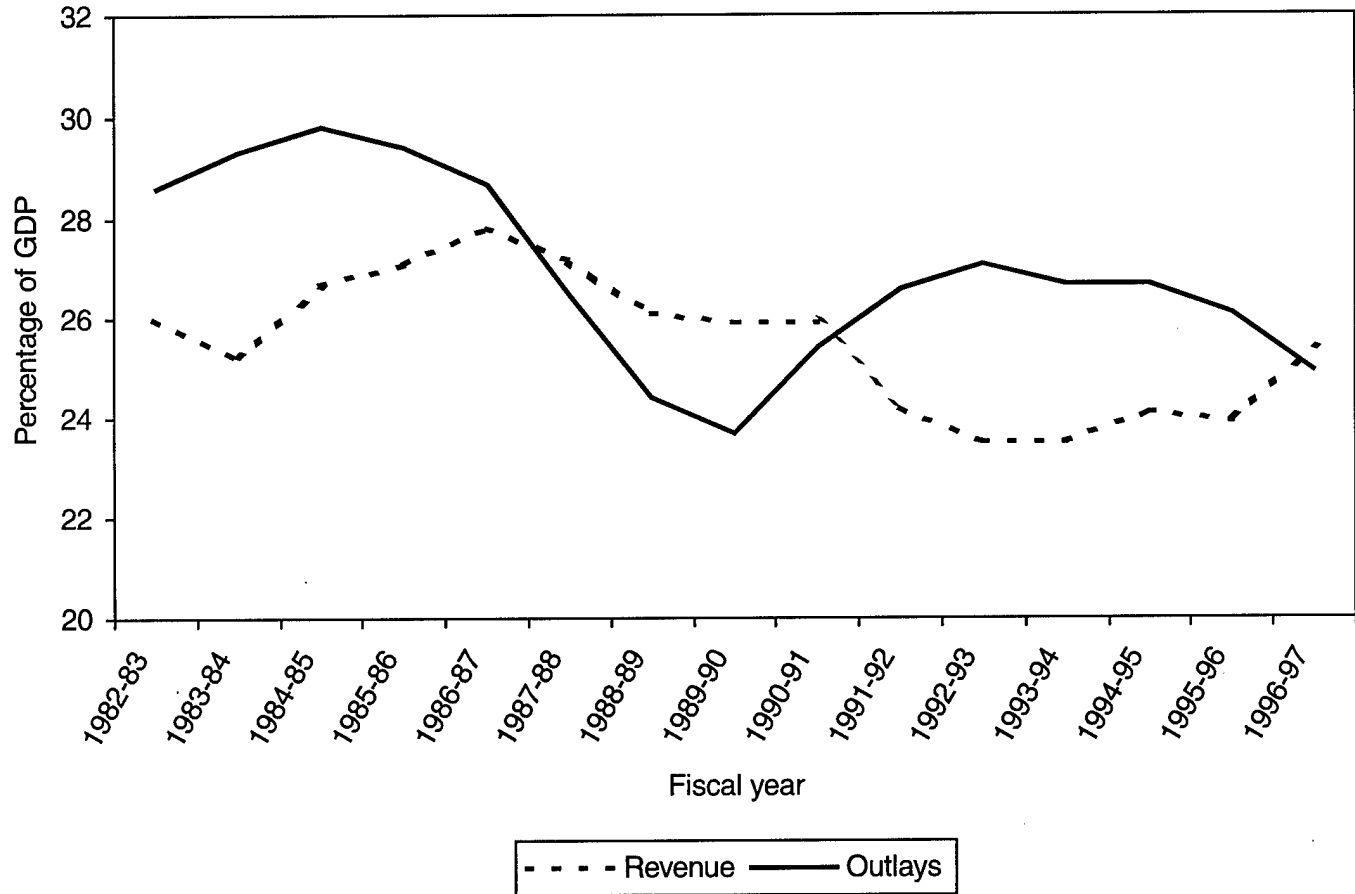
The Labor government that came into power in 1983 did not initially focus on reducing the budget deficit. The government's goals were to reduce unemployment, control inflation, and stimulate the economy. This changed in late 1984 when the Labor government turned its attention to budget deficits. The government was concerned that borrowing in the public sector was crowding out funds available for investment and detracting from Australia's international competitiveness. Specifically, Australia's debt and trade positions were worsening, and in 1986 the Australian dollar suffered a sharp depreciation. These factors combined to create a sense of

crisis. The government decided to reduce its budget deficits to reassure foreign capital markets that something was being done to address fiscal and economic problems.

In 1985, the government first articulated the need for fiscal restraint in terms of the interest burden, arguing that a public debt interest bill of nearly 10 percent of total outlays reduces the flexibility of the government to direct spending in other areas. In 1986, the government argued that further fiscal consolidation would improve the current account deficit and reduce external indebtedness.¹⁰ As the government championed its fiscal goal to reduce deficits as a percentage of GDP, expenditure restraint became the primary means of correcting fiscal imbalances. (See figure 15.) Deficit reduction efforts were aided initially by larger than anticipated increases in revenues resulting from a strengthening economy.

¹⁰The current account balance is the difference between goods and services bought and sold abroad.

Figure 15: Receipts and Outlays in Australia, 1982-83 to 1996-97



Source: *Budget Statements 1995-96 and 1996-97, Budget Strategy and Outlook, 1998-99.*

In fiscal year 1985-86, social security and welfare and transfers to states accounted for 47 percent of total Commonwealth government outlays, and were the 2 areas most affected by deficit reduction efforts. In social programs, the government implemented means-testing and narrowed eligibility requirements. Also, the Commonwealth government greatly reduced general-purpose grants to states. While some general-purpose grants were replaced by specific-purpose grants, the latter only partially offset the reduction in the former. As a percentage of outlays, general-purpose grants decreased from almost 20 percent of total outlays in fiscal year 1985-86 to about 15 percent in fiscal year 1990-91.

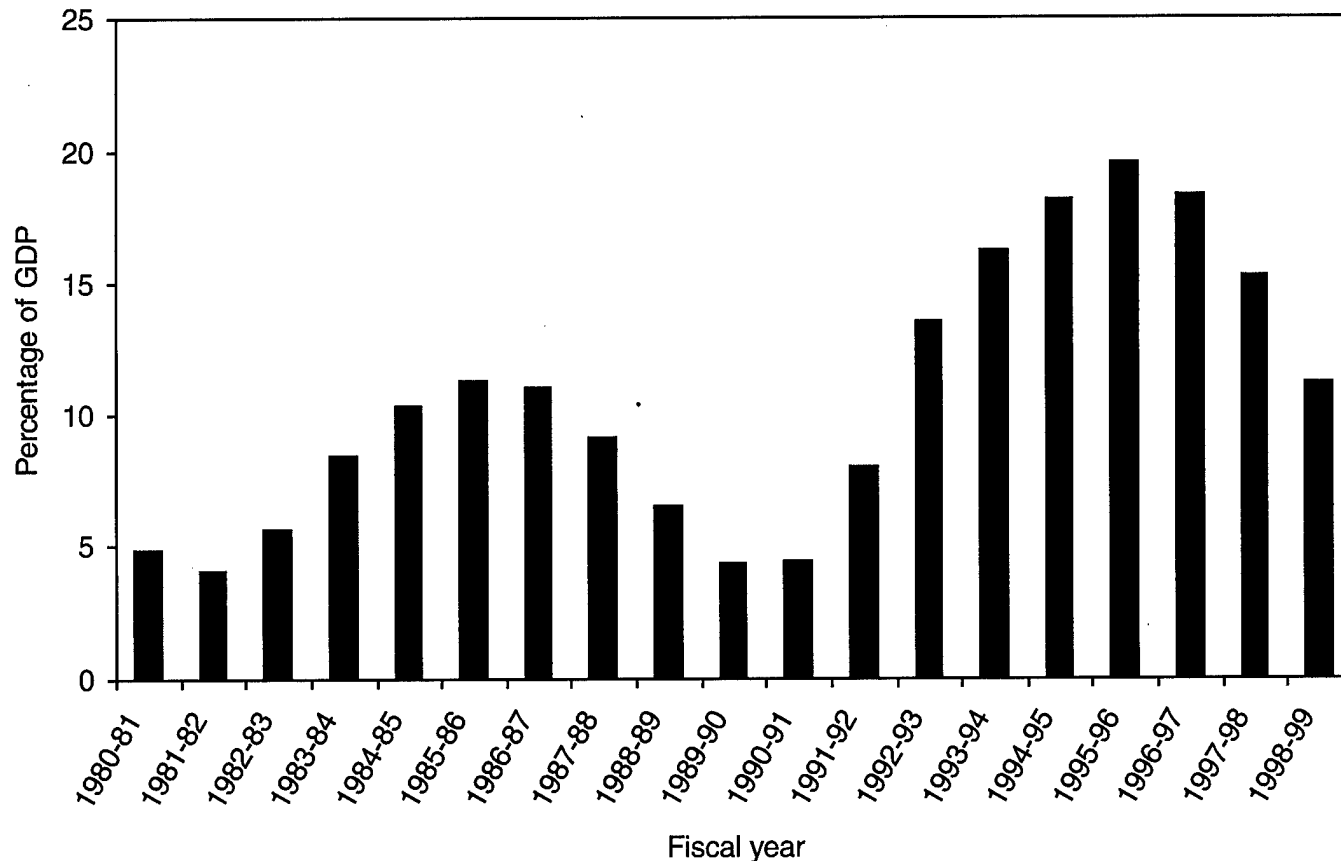
In 1985, the Commonwealth government also instituted a major tax reform package. The reform was not aimed at deficit reduction, but it was instead designed to improve the tax structure, broaden the tax base, reduce tax avoidance and evasion, while not increasing the overall tax burden. The reform eliminated several tax expenditures, introduced new taxes on capital gains and employer-paid fringe benefits, and reduced personal tax rates.¹¹

**The First Surplus Period:
Fiscal Years 1987-88
Through 1990-1991**

As a result of strong economic growth and spending restraints, the government achieved surpluses for 4 consecutive years from fiscal years 1987-88 through 1990-91. These surpluses and proceeds from asset sales were used to substantially reduce the Commonwealth government's debt both in nominal terms and as a share of GDP. From fiscal year 1987-88 to fiscal year 1990-91, public net debt declined from an estimated A\$27.4 billion to A\$16.9 billion, and the debt to GDP ratio dropped from an estimated 9.1 to 4.4 percent. Figure 16 shows that the public net debt to GDP ratio decreased during the surplus period in the late 1980s, increased after the recession in 1991, and started to decrease again in fiscal year 1996-97.

¹¹The capital gains tax did not take effect until 1986-87, and therefore was not payable until the 1987-88 budget year. Tax expenditures are reductions in tax liabilities that result from preferential provisions in the tax code, such as exemptions and exclusions from taxation, deductions, credits, deferrals, and preferential tax rates.

Figure 16: Net Public Sector Debt in Australia, Fiscal Years 1980-81 Through 1998-99



Note: Fiscal years 1997-98 and 1998-99 data are estimated.

Source: *Budget Strategy and Outlook*, 1998-99.

The government's primary fiscal objective during its surplus period was to ensure that fiscal policy made no overall "call" on national saving—i.e., that the government would, on average, run balanced budgets, and thereby not absorb resources available for private capital formation through its borrowing actions. In accordance with this policy, and with the additional goal of reducing outlays as a percentage of GDP, the government continued to cut aggregate spending. At the same time, the government cut income taxes in the 4 years of surpluses. Overall, the government did not pursue an active policy aimed at maintaining surpluses.

Consistent with a goal of reduced expenditures, the government continued to reduce spending even after surpluses were achieved. Nearly all areas of spending declined as a percentage of GDP, although some received small increases. Overall, outlays dropped from nearly 27 to less than 24 percent of GDP from fiscal years 1987-88 to 1989-90. Transfers to states were the focus of spending cuts. For example, from fiscal years 1987-88 to 1991-92, policy actions reduced outlays to states by a total of A\$9.5 billion, an average of 0.5 percent of GDP per year. Consequently, grants to states as a percent of outlays dropped from about 19 to about 13 percent in this 5-year period. These reductions were a major contributor to the government's ability to sustain the surplus.

During the surplus period Australia cut taxes several times.¹² As the result of promises made when revenue raising measures were introduced in the 1985 tax reform package, the government enacted substantial cuts to personal income taxes, with the first cut occurring in December 1986 and affecting tax receipts in 1987—the first year of surpluses. The drop in the top marginal tax rate from 60 to 49 percent would have decreased tax revenues by 2 percent had it not been offset by new taxes on capital gains and employer benefits and base broadening measures. After a surplus was forecast for fiscal year 1989-90, the government made further cuts to income tax rates, and increased tax rebates for families with dependents and for single parents. The new round of cuts reduced the top marginal rate further to 47 percent, for a total reduction of 13 percentage points from the 1986 level. This policy decision reduced revenues by more than 1.5 percent of GDP annually beginning in fiscal year 1989-90. In fiscal year 1990-91, the last year of surpluses, the Labor government made further cuts in personal income taxes for low and middle-income taxpayers. In fiscal year 1990-91, revenues were 25.5 percent of GDP, down from 27.3 percent of GDP in fiscal year 1987-88.

**Fiscal Years 1991-92
Through 1996-97: A Second
Period of Deficits**

In 1991, Australia experienced a short but severe recession. The recession reduced revenue, already at a 12-year low as a result of several rounds of tax cuts, to only 23.5 percent of GDP by fiscal year 1992-93. At the same time, the recession led to increased spending in economically sensitive programs such as unemployment and social welfare. In 1992, the

¹²Since the Australian income tax system is not indexed for inflation, some of these cuts were to offset the effects of "bracket creep." Bracket creep occurs when taxpayers move into higher tax brackets as their incomes grow due to the effects of inflation.

government implemented a major employment initiative and increased assistance to industry in an effort to address the unemployment problem and stimulate the economy. The decrease in revenue—from the recession—and increase in spending resulted in deficits beginning in fiscal year 1991-92, which peaked at 3.6 percent of GDP in fiscal year 1992-93. Deficits remained until after the end of the Labor government's term in 1996.

Beginning in fiscal year 1996-97, the newly elected government made numerous cuts in spending in an attempt to eliminate budget deficits. They also made selected tax cuts, but these were mostly offset by cuts to some tax expenditures and new tax surcharges on high-income earners. The combined effects of policy decisions made in fiscal years 1996-97 and 1997-98 budgets improved the budget balance by a total of 1.8 percent of GDP. These spending and tax actions and a strong economy led to a surplus at the end of fiscal year 1997-98.

In addition, a large privatization effort by the new government helped greatly to reduce Australia's debt level. Privatization proceeds totaled more than A\$23 billion in fiscal year 1996-97 and the first half of fiscal year 1997-98. The underlying balance—Australia's new primary measure of fiscal position—does not include proceeds from asset sales. Consequently, while privatization proceeds did not contribute to Australia's fiscal improvement as measured, they did directly go to reducing public debt, which decreased from 19.5 percent of GDP in fiscal year 1995-96 to an estimated 15.3 percent in fiscal year 1997-98.

A New Framework for Fiscal Decision-Making

When the new government came to power in 1996, it introduced a new framework for fiscal decision-making called the "Charter of Budget Honesty" (the Charter). The Charter set out principles for the conduct of sound fiscal policy and put in place institutional arrangements designed to improve discipline, transparency, and accountability in the formulation of fiscal policy. The Charter was introduced in part to address the perceived lack of transparency in the reporting of a government's financial position, especially during election time. Specifically, the new government pointed to its discovery upon assuming office that the Commonwealth was in actual deficit of about 2.1 percent of GDP, as compared to a forecast of a balanced budget.

The Charter established the following five principles for sound fiscal management: (1) to maintain prudent levels of debt, (2) to ensure that fiscal policy contributes to national saving and moderates economic fluctuations,

(3) to pursue a policy of stable and predictable tax burdens, (4) to maintain the integrity of the tax system, and (5) to ensure that policy decisions consider impacts on future generations. The framework of the Charter allows flexibility for the government to define its medium-term fiscal strategy and short-term fiscal goals in such a way as to fulfill these principles.

To improve discipline, accountability, and transparency, the Charter also requires frequent reporting on fiscal policies. The Charter requires the issuance of fiscal strategy statements at or before the time the budget is presented. Subsequent reports, such as the "Budget and Fiscal Outlook" and the "Mid-Year Economic and Fiscal Outlook," are to contain, respectively, information on how the government intends to implement its strategy and updated information for an assessment of actual fiscal performance compared to the government's plans. The Charter also requires that during an election, cost estimates be prepared by the Department of Finance and Administration and the Department of Treasury for election commitments made by both the government and, if requested, the opposition. The Charter also calls for intergenerational reports every 5 years and for the publication of updated information on the status of economic and fiscal policies 10 days after an election is called.

A Second Period of Surpluses

In fiscal year 1997-98, Australia achieved a budget surplus, and with the fiscal year 1999-2000 budget, the government forecasts surpluses for the next 4 years. The government's medium-term fiscal strategy, developed as required by the Charter, is to balance the budget over the cycle. As a result, the Government's current fiscal policy has a short-term goal of running surpluses during the current period of expansion that is forecast. Also, the government is projecting that debt will be eliminated by 2002-03.¹³

Within this goal of surpluses for the short-term, the government has made room for new spending increases and selective tax cuts. The fiscal year 1998-99 budget proposed spending initiatives totaling nearly A\$10 billion through fiscal year 2001-02, with a large portion dedicated to health care.

¹³In mid-1998, the government proposed reducing debt to about 1½ percent of GDP by fiscal year 2001-2002 by selling its remaining equity in Telstra—the government's telephone monopoly. While the Senate has rejected the government's proposal, it recently approved the sale of an additional 16 percent of Telstra.

The government also proposed to cut personal income tax rates and introduced a taxation rebate for savings.

The main difference between the first and the second surplus period is that the new government's policy explicitly calls for surpluses over the short-term, concurrent with economic expansion. This is due in part to the new requirements under the Charter of Budget Honesty that governments spell out the medium-term fiscal policy and assess its impact on national saving. The fiscal year 1996-97 budget set out to achieve balance within 3 years, before the end of the government's first term in Parliament. The medium-term strategy was that the underlying budget should be in balance on average over the course of the economic cycle. After it became apparent that the surplus would materialize before the end of the 3-year cycle, the government reaffirmed its commitment to balance over the cycle. For this government, achieving balance over the cycle meant that it had to achieve surpluses during the remaining years of the present economic expansion.

Such cyclical balance has not always been achieved. As far back as fiscal year 1996-97, the government warned that the deterioration in fiscal position that occurred during economic slowdowns in the previous 20 years was only partly, and sometimes not at all, offset by surpluses during periods of strong growth. Consequently, the government is now aiming for surpluses while the economy is growing, reducing debt, and providing extra capacity for the government to use fiscal policy to run deficits when the economy is weak. According to current projections, and due to continued expansion in the Australian economy, the government appears poised to eliminate net debt by fiscal year 2002-03.

Tax Reform

Fiscal arrangements in Australia are characterized by a significant difference between the relative revenue and expenditure responsibility of the Commonwealth and the states—referred to as vertical fiscal imbalance. States are unable to raise revenues sufficient to cover their obligations and must rely on the federal government to make up the difference. For example, the federal government in fiscal year 1997-98 raised 72 percent of total government revenue but was responsible for only about 57 percent of total government spending, the states accounting for most of the remainder. As a result, states are heavily reliant on the Commonwealth for a significant share of their revenue.

The states' ability to raise revenues is limited by several factors. First, the Australian Constitution denies states the power to levy certain taxes,

including retail and wholesale taxes on goods and services. Also, the states relinquished the power to tax income to the Commonwealth in World War II. As a result, states rely on many land, payroll, and miscellaneous taxes for their revenue. Recently, the states' ability to raise revenues was further limited by a Supreme Court decision in 1997 that ruled that state tobacco franchise fees were unconstitutional.

Against this backdrop, and with a forecast of budget surpluses, the Coalition government campaigned in the 1998 election on a tax reform platform to introduce the Goods and Services Tax (GST). As conceived, the GST would be a broad-based sales tax levied on all goods and services. The GST revenues would go to state governments, thereby greatly reducing the reliance of states on the Commonwealth. To offset this, general-purpose assistance to state governments would no longer be available while the wholesale sales tax and nine other state taxes would be eliminated. The GST proposal is mostly revenue neutral. However, due to concerns that a GST would be regressive—i.e., that it would fall most heavily on low-wage earners—the government also proposed to use budget surpluses to finance a reduction in personal income tax rates and an increased threshold for family benefits.

The Coalition government was reelected in 1998. After extensive negotiation and compromises—including major new anti-tax avoidance measures, reduced income tax cuts, and the elimination of food from the GST—the Parliament finally passed a tax package in June 1999, with the GST expected to go into effect starting July 1, 2000. The new compromise tax package includes tax cut provisions totaling A\$12 billion, funded in part from the underlying surpluses forecasted in the 1998-99 budget. Nevertheless, the government projects continued underlying surpluses through at least fiscal year 2002-03.

Long-term Pressures and Reforms

Australia has a relatively younger age profile than most developed countries. However, the proportion of the population aged 65 and over is projected to grow from about 11 to over 19 percent between 1991 and 2030. During the same period, the ratio of working age population to retirees is projected to decrease from 6 to 3.3. However, many officials we talked with remained optimistic that the budget impact of an aging population would not be too severe.

Australia's pension system is made up of a flat rate, means-tested public pension program, and a mandatory superannuation program funded from

employers' contributions. Public pensions are financed from general government revenue and account for less than 3 percent of GDP. Pension benefits are not related to an individual's prior earnings, but they are subject to means testing based on income and assets. Benefits are legislated so as not to fall below 25 percent of annualized male total average weekly earnings.

The superannuation portion of the pension system is a mandatory, employer-funded program. This program started in 1986 when, in an effort to rein in inflation pressures, the Labor government put in place a program whereby employers contributed to individual pension accounts—superannuation—in exchange for real wage reductions. While superannuation benefits had always been available to selected employees in professional occupations, the 1986 program extended coverage so that by 1991 more than 72 percent of employees were covered, up from 42 percent in 1982. In 1992, the Commonwealth passed the Superannuation Guarantee Act to extend employer-based retirement benefits to almost all employees.¹⁴ The act required the employers to make pension contributions to individual pension accounts of the employees' choosing. By 1996, approximately 89 percent of both public and private sector employees were covered by superannuation, with the remaining 11 percent of the work force falling below the income threshold where superannuation started to apply.

According to officials we interviewed, the 1992 reform was not undertaken to reduce pressure on the budget. Estimates show that in the absence of superannuation, public pensions would only have grown to 5 percent of GDP in 2050, compared to 4.7 percent with superannuation. Rather, the reforms were undertaken primarily to ensure that the elderly population could retire comfortably by extending superannuation to the entire workforce.

While a growth in the elderly population is predicted to have little effect on pension spending, officials we interviewed cited concerns about the pressure of an elderly population on health care cost and quality. Officials in the Department of Health and Family Services further added that the pressure would not come from aging per se, but from improved technology and public expectations. For example, officials informed us that health

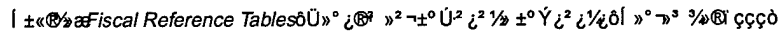
¹⁴The Superannuation Guarantee Act established an income threshold—less than A\$450 per month—under which employers do not have to pay superannuation benefits.

care costs had increased recently by more than 3.5 percent annually. Of this, only about 0.6 percent was due to the aging of the population, with the remainder attributable to increased expectations and technological development. However, long-term fiscal pressures have generally not been a part of any debate about what to do with budget surpluses.

Conclusion

Australia experienced a period of budget surpluses in the late 1980s and early 1990s that was largely the result of its deficit reduction efforts of the early 1980s and a strong economy. During this period, Australia's main fiscal policy goal was to balance the budget. However, governments continued to cut spending throughout this period while giving fairly large tax cuts. As the economy slipped into a short but severe recession in the early 1990s, Australia again ran deficits. In 1996, a newly elected government initiated a deficit reduction program and put in place a new framework for setting fiscal policy, which called for the government in power to consider certain factors, such as national saving and the public debt level, when setting fiscal policy. As a result of the deficit reduction program and increased economic growth, budget surpluses reoccurred in fiscal year 1997-98. Under the new framework, the government is calling for surpluses over the immediate period of economic expansion. In 1999, the government passed a tax reform package containing tax cut provisions totaling about A\$12 billion. Nevertheless, the government continues to project underlying budget surpluses for fiscal year 1999-2000 and the following 3 fiscal years.

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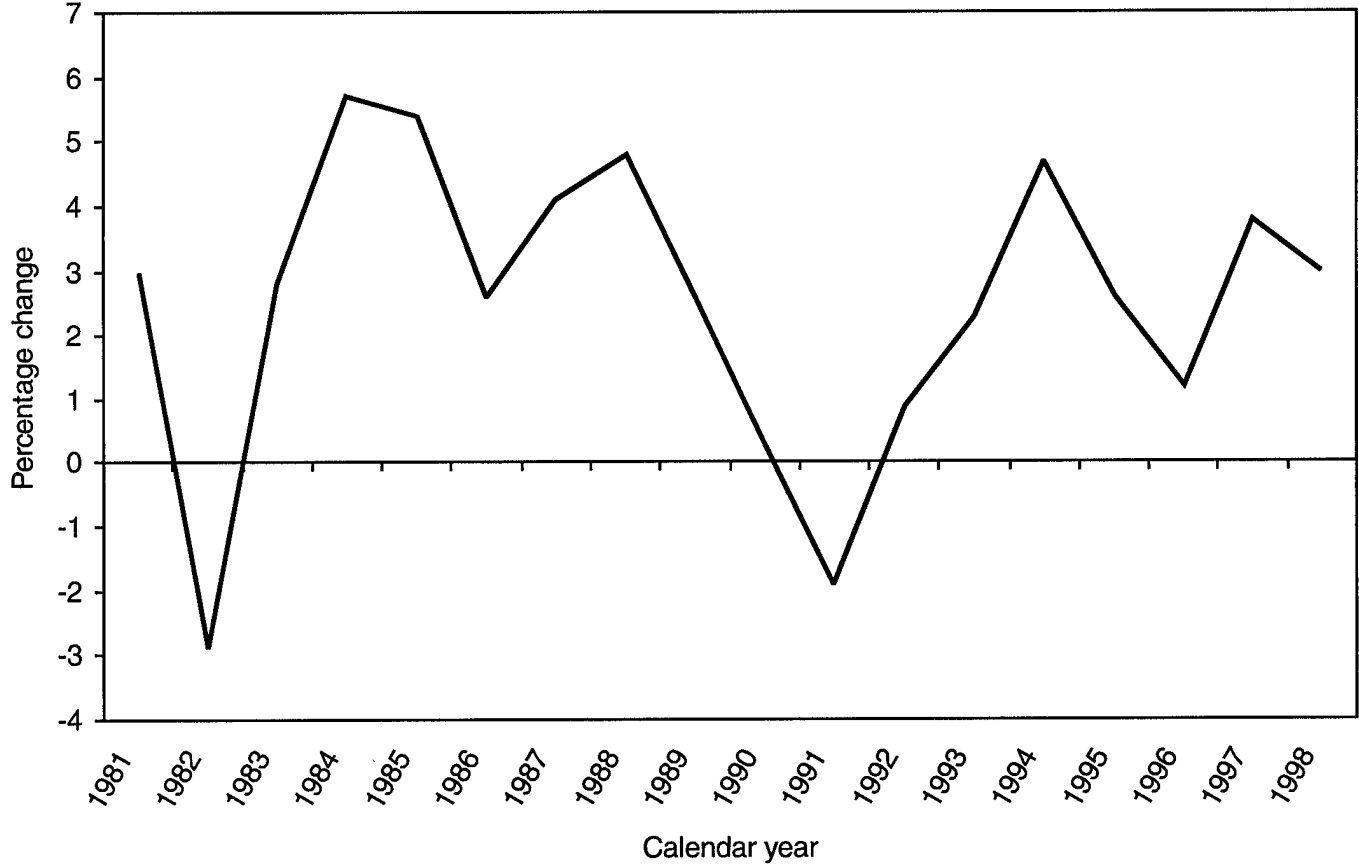
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[illegible][illegible]

efforts by the government to restrain spending. By fiscal year 1992-93, the deficit had risen to nearly 6 percent of GDP. Consequently, the debt burden, which had stabilized in the late 1980s, began rising rapidly again, going from 57.6 percent of GDP in fiscal year 1990-91 to 71.1 percent of GDP in 1994-95.

New Government Confronts Growing Fiscal Crisis

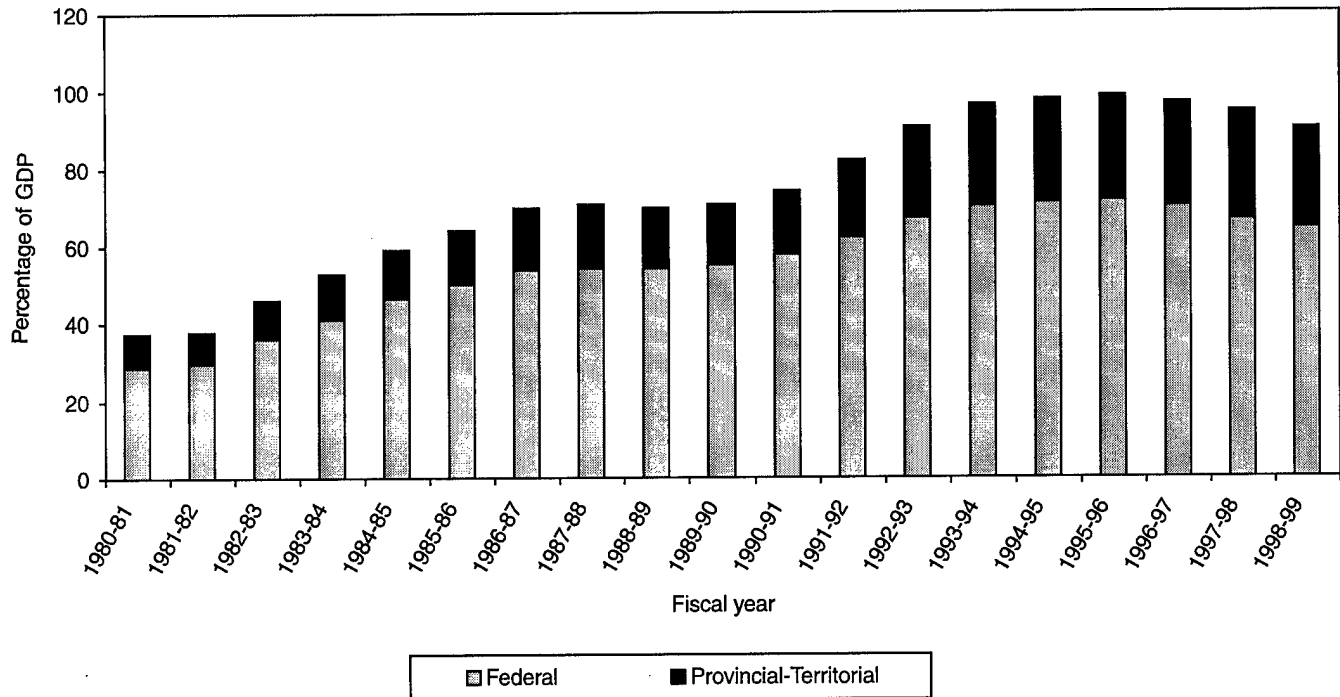
A newly elected Liberal government came to power in 1993 pledging to reduce the deficit to 3 percent of GDP over 3 years.¹⁷ Both this target and the government's initial budget were criticized by some as too modest. However, a fiscal crisis beginning in 1994 led the government to take more radical steps to reduce the deficit.

During 1994 and early 1995, Canada's fiscal outlook deteriorated quickly. The situation worsened due to a sharp rise in interest rates, which rose in response to interest rate hikes in the United States and partly due to concerns in the international investment community about Canada's large debt burden. Long-term interest rates in 1994 turned out to be 2 percentage points higher than the Finance Department's original projections, even though these projections had been intended to reflect conservative assumptions. Canada's large federal debt burden and its associated interest payments made federal finances particularly vulnerable to higher interest rates. For example, in 1994, the Finance Department estimated that a 1 percentage point increase in interest rates would raise interest expenditures by CAN\$1.7 billion in the first year—0.23 percent of GDP. Growing interest expenses threatened the government's ability to achieve its 3 percent deficit to GDP target in fiscal year 1996-97.

Adding to the sense of fiscal crisis in 1994 was the decline in provincial finances that occurred in the early 1990s. The aggregate provincial deficit rose from 0.7 percent of GDP in fiscal year 1989-90 to 3.6 percent of GDP in 1992-93. As at the federal level, these deficits resulted in a rapidly rising debt burden. Together, the federal and provincial debt approached 100 percent of GDP during the mid-1990s. (See figure 19.) According to an analyst we interviewed, the 100 percent level had an unsettling psychological effect.

¹⁷This target consciously echoed the deficit ceiling set for countries participating in the European Monetary Union.

Figure 19: Federal and Provincial-Territorial Net Debt in Canada, 1980-81 to 1998-99



Note: 1998-99 data for provincial-territorial net debt is an estimate.

Sources: *Fiscal Reference Tables*, Department of Finance of Canada, September 1999, and *The Budget Plan 1999*, Department of Finance of Canada, February 1999.

Canada's declining fiscal fortunes and its vulnerability to future economic shocks convinced the federal government of the need for comprehensive structural changes in the fiscal year 1995-96 budget. These changes were considered necessary to ensure that the 3 percent deficit to GDP target would be met. In the fall of 1994, the government laid the groundwork for its 1995-96 budget with the publication of two reports. The first report—known as the Purple book after the color of its cover—outlined in detail the origins and implications of the nation's current economic and fiscal difficulties. The second report—called the Grey book—was a fiscal update that was intended to encourage a public dialogue by discussing the scope of the budget challenge.

The Purple book emphasized Canada's spiraling debt burden and how it posed a major threat to the government's economic agenda:

"Returning Canada to fiscal health is a prerequisite to achieving all of the other elements of the [government's] economic strategy....Increasing productivity and sustained job growth are the results of investment, of entrepreneurial vigour, and of consumer confidence. All are being undermined by a growing public debt that has led to higher taxes, higher real interest rates, and a diminished capacity of the Government of Canada to address the other vital issues of an economic strategy for the future."¹⁸

Since the fundamental problem outlined in the government's analysis was the debt burden, the solution was to break the vicious circle of high deficits, a growing debt burden, and rising interest costs. The government concluded that achieving this goal would require a major effort to reduce, and eventually eliminate, the deficit and to set the debt to GDP ratio on a declining path. The deficit reduction efforts were to be based heavily on spending restraint because the government concluded that the revenue burden was already very high and, over the long term, should be reduced. The government reinforced its commitment to solving the fiscal problem with a promise by Finance Minister Paul Martin to reach the 3 percent deficit to GDP target "come hell or high water."

In assembling the fiscal year 1995-96 budget, the government relied on comprehensive reviews of government programs to generate the savings needed for the deficit reduction package. An assessment called "Program Review" covered most components of direct program spending (which excludes major transfer payments to individuals and other levels of government). Under this review, the Finance Department determined spending cut targets for each ministry, and the ministries were responsible for assembling a detailed plan to meet these targets. A governmentwide Committee of Ministers was charged with overseeing the budget plans proposed by the ministries under the Program Review process. In addition to the Program Review, the government conducted assessments of major transfer programs to the provinces and territories and employment insurance benefits.

As the budget was prepared, the fiscal outlook continued to deteriorate. The economic crisis experienced by Mexico in late 1994 raised concerns in the international investment community about the potential for similar problems in Canada. Investors responded by shifting some of their assets out of Canada. This asset shift further pushed up Canadian interest rates, pushed down the Canadian dollar, and added a clear element of crisis to

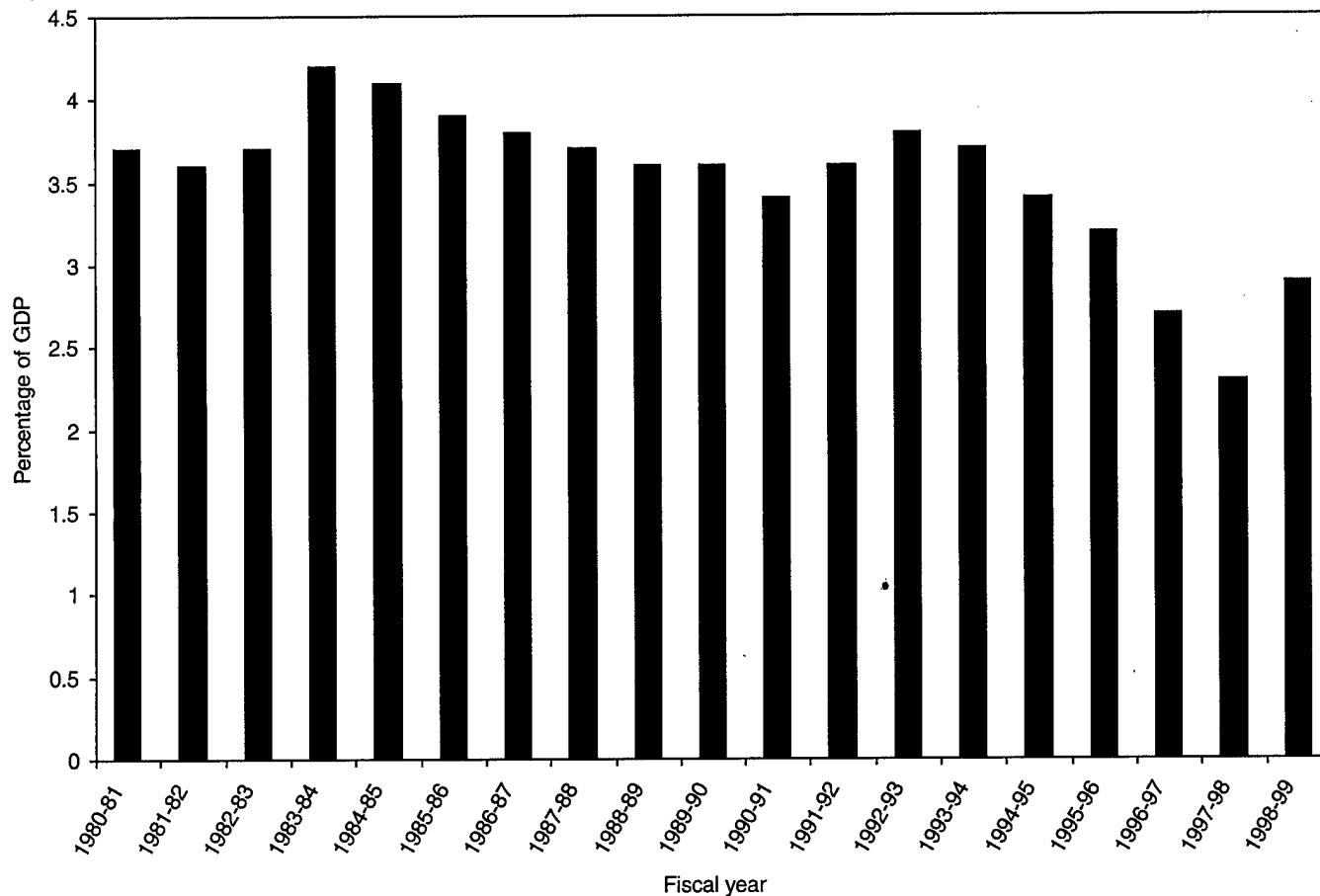
¹⁸*A New Framework for Economic Policy*, Government of Canada, Department of Finance, 1994, p. 71.

federal budget preparations. The government was very concerned about Canada's vulnerability to foreign investors. The Grey book emphasized that Canada's deficits and debt were among the highest of major industrial countries. Likewise, the nation's foreign debt—public and private combined—was also high, reaching 44 percent of GDP by the end of 1993. The result was that foreign investors demanded higher interest rates on Canadian debt to compensate for its perceived riskiness compared to the debt risk posed by other major industrial countries.

According to an account of the period, to help ensure that the budget would be well received by financial markets, the Finance Department increased the amount of deficit reduction planned for the fiscal year 1995-96 budget. Finance Minister Martin was concerned that if the financial markets judged the fiscal restraint in Canada's budget to be insufficient, the government might be forced into revising its plans. A negative reaction from the financial community could result in a downgrade to Canada's bond rating, and further declines in the currency, which had already reached an 8½-year low against the U.S. dollar. This posed a significant risk as a decline in the value of the Canadian dollar would make foreign-denominated debt more expensive to repay.

The final fiscal year 1995-96 budget included CAN\$5 billion in deficit reduction measures in the first year, and CAN\$29 billion over 3 years. In the budget, these measures were described as "by far the largest set of actions in any Canadian budget since post-war demobilization." For every dollar of revenue increases there were nearly 7 dollars of spending cuts. The reductions affected nearly every government department. Major cuts included the extension of a pay freeze on public employee salaries, the elimination of 15 percent of the federal workforce, and a large reduction in subsidies to businesses, such as railways, agricultural industries, and cultural industries. In addition, a major restructuring of provincial aid was announced that would take effect in the following fiscal year. The two major social services grants to the provinces covering health care, education, and welfare were combined into one block grant and funding was cut substantially. (See figure 20.) For more information on this change in provincial aid, see figure 21 on The Canada Health and Social Transfer.

Figure 20: Major Federal Transfers to Other Levels of Government in Canada, 1980-81 to 1998-99



Note: Includes the Canada Health and Social Transfer, fiscal transfers, insurance and medical care, Canada Assistance Plan, and education support.

Source: *Fiscal Reference Tables*, Department of Finance of Canada, September 1999.

Figure 21: The Canada Health and Social Transfer

The Canada Health and Social Transfer (CHST)

CHST is a block grant program designed to help provinces and territories fund health care, post-secondary education, social assistance, and social services. CHST came into effect on April 1, 1996, 1 year after being announced in the fiscal year 1995-96 federal budget. CHST replaced two existing transfer programs, the Canada Assistance Plan (CAP) and Established Programs Financing (EPF). CAP was a cost-sharing arrangement for welfare and social services and EPF was a block grant that helped finance health care and post-secondary education. The introduction of CHST represented a shift in the federal/provincial fiscal relationship. With a block grant program, provincial spending decisions would no longer determine the level of federal transfers and thus the federal government could more easily control its own spending in this area.

When CHST went into effect, cash payments to the provinces decreased. Cash payments under CHST in 1996-97 were CAN\$3.8 billion less than the CAN\$18.5 billion provided via EPF and CAP in 1995-96 and fell to CAN\$12.5 billion in 1997-98. As federal finances have improved, the government has allocated additional resources to CHST. In December 1997, the federal government increased the CHST cash floor from CAN\$11 billion to CAN\$12.5 billion for fiscal year 1997-98 and beyond; the provinces are guaranteed to get at least the value of the cash floor in cash payments through fiscal year 2002-03. Then, in the 1999-2000 budget, the federal government increased CHST cash transfers by CAN\$11.5 billion over 5 years. Though CHST is designed to allow provinces to spend transferred funds as they see fit, in February 1999, provincial premiers and territorial leaders committed to spending all of this additional CAN\$11.5 billion on health care.

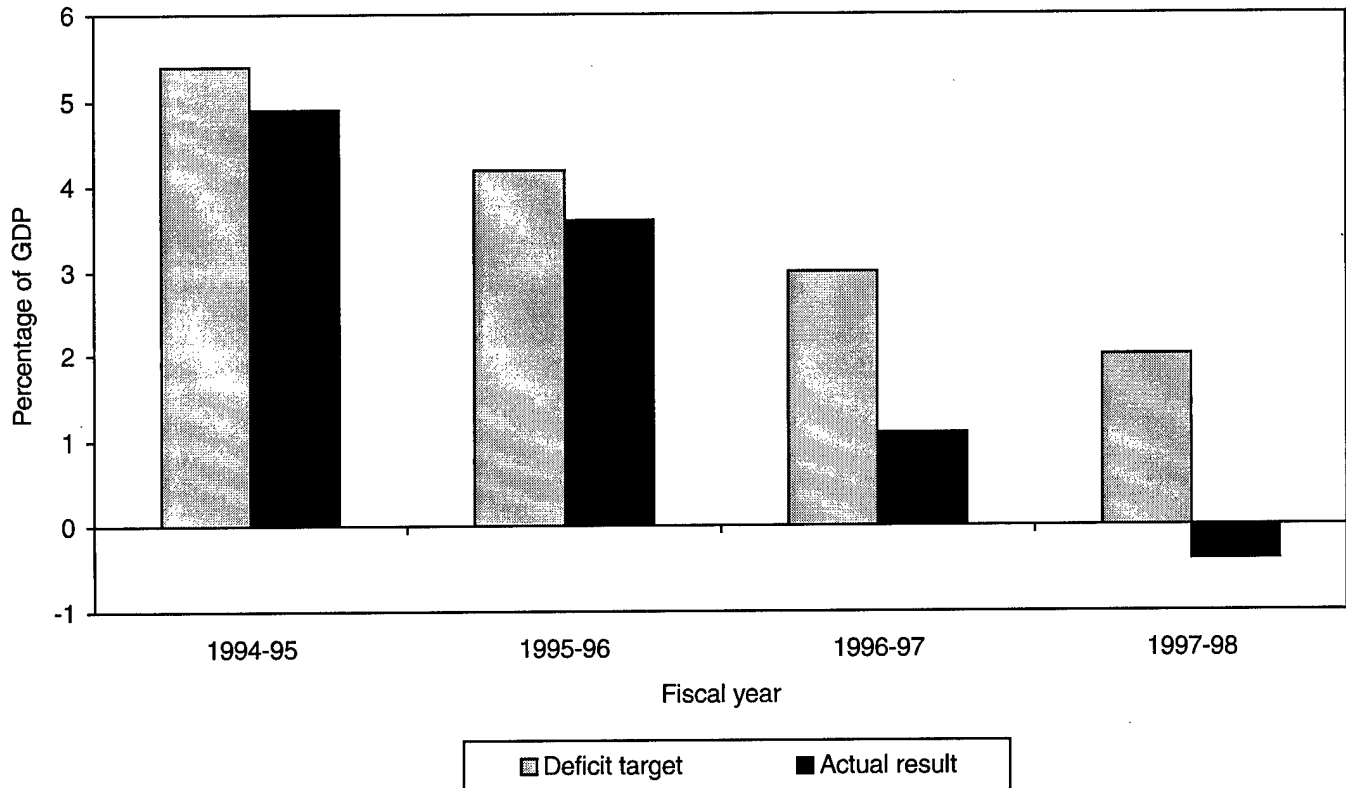
Federal aid to the provinces is not limited to cash payments. In addition to cash transfers, CHST includes tax transfers. A tax transfer takes place when the federal government reduces its tax rates and provincial governments raise their tax rates by an equal amount. In 1977, in conjunction with the establishment of EPF, the federal government transferred 13.5 percentage points of personal income tax and 1 percentage point of corporate income tax to the provinces and territories. The associated tax revenues then began to flow directly to the provinces and territories. Provinces and territories continue to receive these tax revenues and the federal government counts them as part of CHST. Over time, the value of tax transfers grows as provincial economies grow. Without a cash floor, CHST cash payments would eventually be crowded out by the growing value of the tax transfers.

Canada Achieves Rapid
Fiscal Progress In Mid- to
Late 1990s

The deficit reduction packages in the 1994-95 and 1995-96 budgets, along with an improving economy, provided the main impetus for Canada's rapid fiscal progress in the late 1990s. Subsequent budgets have held to the course of fiscal restraint without introducing any major new deficit reduction initiatives.¹⁹ The current government has consistently bettered its fiscal targets, often by a wide margin. For example, the government had promised a deficit of no more than 3 percent of GDP in 1996-97, and the actual result was a deficit of about 1 percent of GDP. (See figure 22.)

¹⁹The 1996 budget did include a proposal for reforming the basic pension and income support benefits provided to Canada's seniors. The proposed Seniors' Benefit was expected to provide cost savings over the long term. However, the government later decided to drop this proposal. In 1997, the federal government and the provinces agreed to a major reform in the earnings-related Canadian Pension Plan. But, since CPP is a separate financial entity, these changes had no impact on the budget.

Figure 22: Deficit Targets Compared to Actual Results in Canada, 1994-95 to 1997-98



Note: Negative number indicates a surplus.

Source: Various Canadian budgets, fiscal years 1994-95 through 1998-99.

To ensure that its targets are met, the government has relied on cautious planning techniques that have become a defining characteristic of its approach to budgeting. These techniques provide a buffer against forecasting errors and unpredictable events. The government's cautious strategy is composed of three main elements: (1) conservative economic assumptions and forecasting methods, (2) a sizable contingency reserve that cannot be tapped for new initiatives, and (3) a 2-year planning period.

Canada's Cautious Budgeting Techniques

The federal government relies on a cautious approach to budget planning that is based on conservative economic and technical assumptions, a contingency reserve, and a short forecast horizon.

The Finance Department uses assumptions for interest rates, and sometimes economic growth, that are intentionally more conservative than private sector forecasts. In developing these assumptions, the department first surveys private forecasters. Then, using the average of these forecasts as a base, it adjusts interest rate projections upward. For example, the adjustment factor for long-term interest rates is typically $\frac{1}{2}$ of 1 percent (50 basis points). This cautious forecasting policy was based on a recommendation from a panel of economists convened in late 1993 to advise the government on fiscal and economic issues. The panel's recommendation was underscored by a private sector analysis that found that the government's economic assumptions in the 1980s and early 1990s tended to be overly optimistic. Under the current government's cautious approach, the Finance Department's economic assumptions have often been more pessimistic than actual outcomes.

The contingency reserve is an annual amount that is built into projected spending, but it is not allocated to any specific program. It is an accounting mechanism used to supplement the government's cautious forecasting policy, rather than an actual cash fund. Under the current government, this reserve is not available to fund new initiatives. Instead, it serves solely as a buffer against unanticipated developments, such as an adverse change in the economy. If the government's budget projections are on target (or overly pessimistic), the reserve acts to reduce the deficit or increase the surplus. For example, in fiscal year 1998-99, the government projected a balanced budget. This balanced budget estimate assumed that the CAN\$3 billion contingency reserve would need to be spent to compensate for shortfalls in the projections. If the budget forecast is exactly on target, the government will actually realize a CAN\$3 billion surplus that will be used to reduce debt.²⁰

The final element in the government's cautious approach is a short forecast horizon; it publishes detailed projections for only 2 years. A short forecast period is not necessarily a more prudent approach to budgeting, but the government explains that its short horizon is a response to the inherent sensitivity of longer-term forecasts to future economic developments. Another important reason for the shorter forecasts is that during a period of deficit reduction they focus attention on making cuts today rather than delaying action until tomorrow. For example, prior to the current

²⁰The realized surplus was actually CAN\$2.9 billion in fiscal year 1998-99, which was used to reduce debt.

government, the Finance Department used a 5-year budgeting time frame for setting fiscal policy and repeatedly failed to meet its deficit targets. In contrast, since fiscal year 1994-95, the current government has consistently bettered its 2-year fiscal targets. The effect of this policy during a time of surplus is to reduce the ability to spend projected surpluses. On the other hand, a short-term budgeting time frame does not disclose the full long-term impact of policy decisions.

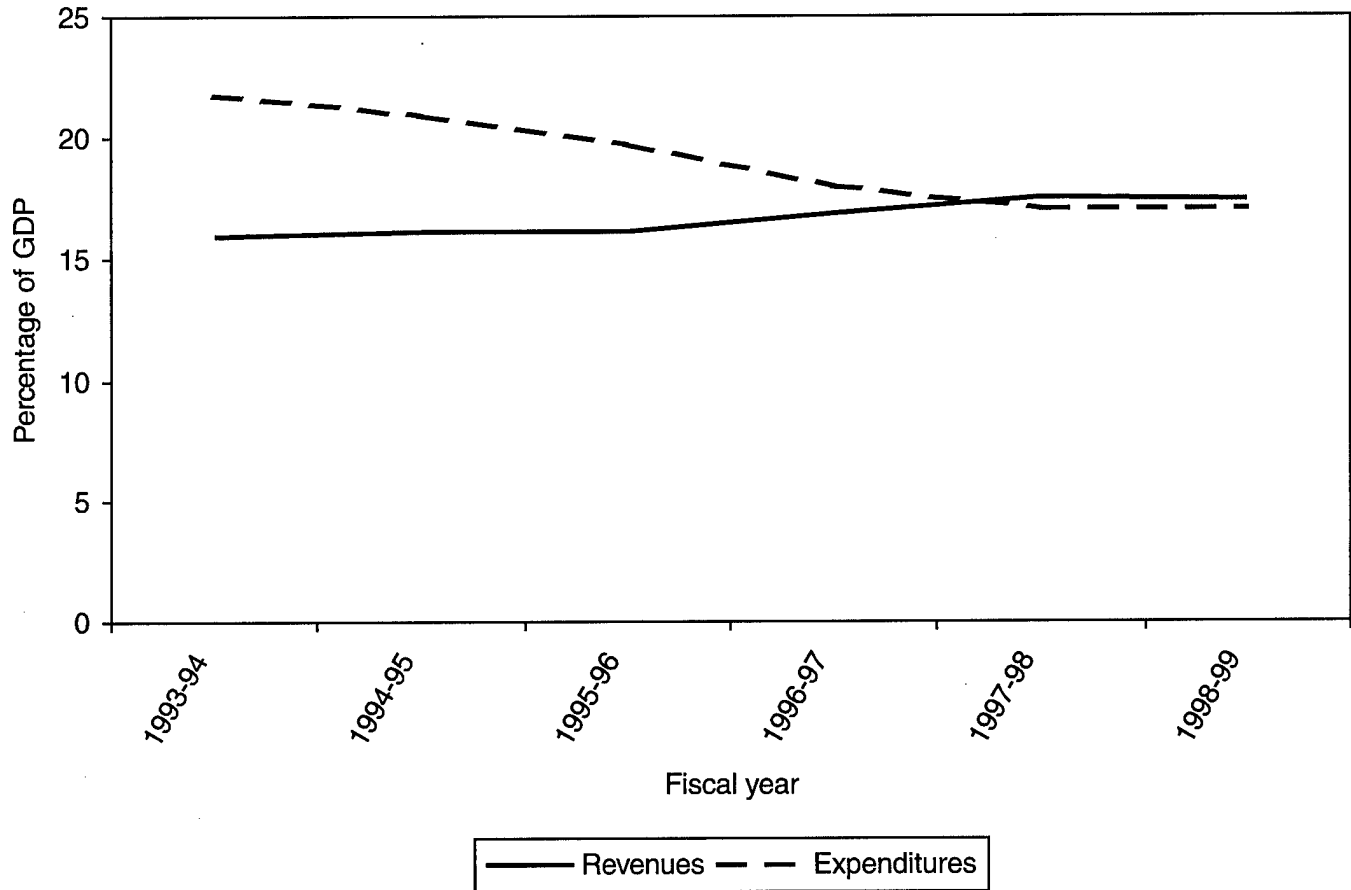
Aided by these cautious planning techniques, the government progressively lowered its deficit target to zero—i.e., a balanced budget. In fiscal year 1997-98, the federal budget registered a small surplus, its first in nearly 30 years. The elimination of the deficit has begun to ease Canada's high federal debt burden. After peaking in fiscal year 1995-96 at just over 70 percent of the economy, it has fallen modestly. The interest burden declined more dramatically, from 36 percent of revenues to just under 27 percent, between fiscal years 1995-96 and 1997-98.²¹ By running balanced budgets and not using the contingency reserve, the government intends to reduce debt as a share of GDP.

The government and the Organization for Economic Cooperation and Development (OECD) attribute the majority of this substantial fiscal improvement to spending restraint rather than increased revenue. (See figure 23.) The 1999-2000 budget estimated that program spending (which excludes interest) will have fallen from 16.6 percent of GDP in 1993-94 to 12.6 percent of GDP in 1998-99. In comparison, the budget estimates that revenues will have risen from 16 to 17.6 percent of GDP over the same period.²²

²¹These figures include interest on internally held government debt, for instance interest on the federal government's employee pension plan.

²²A portion of this revenue increase is due to the partial deindexation of the tax system that was enacted in the 1980s.

Figure 23: Federal Government Revenues and Expenditures in Canada, 1993-94 to 1998-99



Sources: *Fiscal Reference Tables*, Department of Finance of Canada, September 1999.

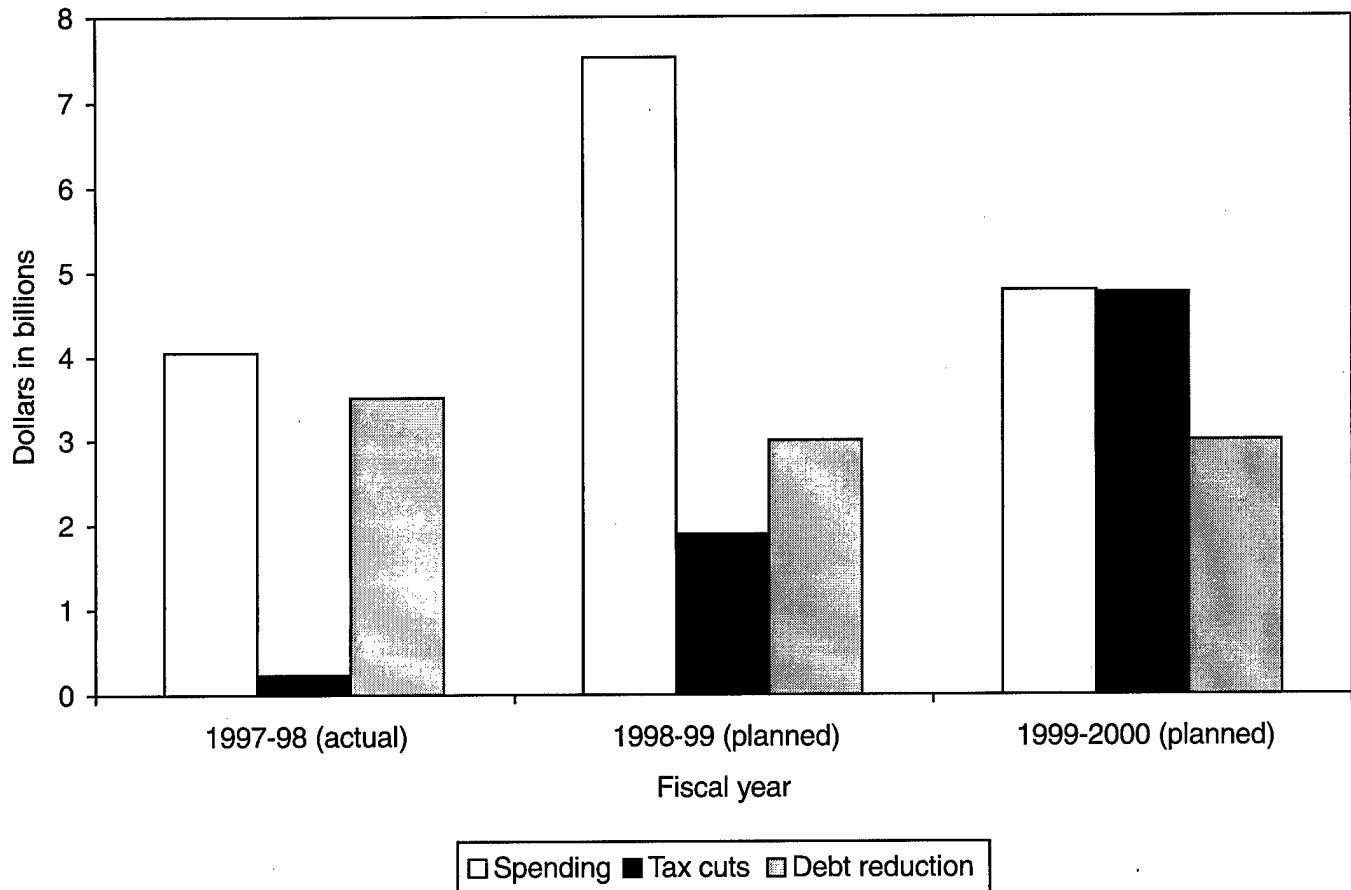
The Debate Over Fiscal Choices During a Period of Surplus

As it has entered a period of budget surpluses, the government has continued to rely on a cautious approach. Excluding the contingency reserve, the Finance Department does not publicly project budget surpluses. The government's current fiscal goal is, at a minimum, a balanced budget—a strategy that it refers to as “balance or better.” However, the contingency reserve implies that the actual target is a surplus of at least CAN\$3 billion, about 0.3 percent of GDP. The government has acknowledged that it anticipates budget surpluses by introducing the Debt Repayment Plan. The plan is an explicit statement that the government's cautious approach could result in budget surpluses and that the contingency reserve would be used to reduce debt. The 1999 Budget Plan states that “the level of debt in relation to the ability to service the debt (the debt-to-GDP ratio) is still too high—both by historical Canadian and international standards. . . Reducing the debt-to-GDP ratio must remain a key objective of the government's fiscal policy.”²³

While the government is committed to using a modest amount of budget surpluses for debt reduction through the contingency reserve, it also uses surplus revenues for new spending and tax cut initiatives. (See figure 24.) This strategy of dividing surpluses between debt reduction, tax cuts, and new spending was articulated during the government's 1997 reelection campaign. At that time, the government stated that it would devote 50 percent of budget surpluses to new spending and the other 50 percent to a combination of tax cuts and debt reduction. Analysts we interviewed stated that this allocation framework applies to surpluses over the full Parliamentary term and will not necessarily be followed on a year-by-year basis.

²³ *The Budget Plan 1999*, Government of Canada, Department of Finance, February 16, 1999, p. 52.

Figure 24: Summary of Spending and Tax Actions in the 1997-98, 1998-99, and 1999-2000 Canadian Federal Budgets



Source: *The Budget Plan 1999*, Department of Finance of Canada, February 1999.

In both the fiscal year 1998-99 and 1999-2000 budgets, the government introduced a number of new spending and tax initiatives. The Finance Department estimates that these initiatives will cost the government about CAN\$50 billion cumulatively from fiscal years 1997-98 through 2001-02. On the spending side, these initiatives have focused on health care and education. The tax changes include an increase in the amount of income that low-income earners can receive tax-free, the elimination of a 3 percent surtax, an increase in the Child Tax Benefit, and a reduction in employment insurance rates for both employers and employees.

In launching new policy initiatives, the government has adopted a philosophy that generally avoids committing resources before they materialize. Typically, the government does not introduce new spending or tax cuts until late in the fiscal year when a surplus becomes apparent. The 1999-2000 budget explained this approach and its rationale as follows:

"Central to [the government's] planning approach is the notion that spending initiatives and tax cuts will be introduced only when the government is reasonably certain that it has the necessary resources to do so. This protects against the risk of having to make hasty, and potentially damaging, corrections to the budget plan, such as announcing tax relief one year and then having to raise taxes the following year."

In line with this cautious approach, the government has generally shied away from both large-scale spending commitments and major tax cuts. In addition, the government has enacted nonpermanent spending initiatives, showing its preference for limiting future commitments. An example is the Canada Millennium Scholarship Fund. The full cost of the fund—a nonrecurring CAN\$2.5 billion—was booked in fiscal year 1997-98, though scholarships will not be awarded until 2000. The government has also made many nonpermanent investments for health care, research, and education. This careful strategy for allocating extra resources is supported by the Finance Department's use of conservative economic assumptions, which tend to understate the resources available for spending.

Recent Critiques of Cautious Budgeting During a Period of Surplus

While the government's deficit reduction strategy received widespread support, as Canada entered a period of surplus many fiscal analysts have criticized some of the government's techniques. Although many of these critics support the general notion of cautious planning, they suggest that the degree of caution used by the government is excessive. A pervasive concern is that, while the government officially targets a balanced budget, its cautious techniques result in "stealth surpluses." According to a number of analysts and social advocates from both sides of the political spectrum we interviewed, understating the size and duration of expected surpluses precludes a full-scale public debate over how to allocate these additional resources.

Several different techniques may contribute to understating budget surpluses. These techniques fall in two distinct groups: (1) the planning assumptions that were developed during the period of deficit reduction and (2) the practices adopted by the government for allocating surplus revenues.

Planning Assumptions

Some analysts have criticized the government's continued use of a 2-year time frame for budget planning. They assert that this short horizon makes it harder to argue either for permanent spending or tax changes or for initiatives with benefits realized over a longer period, such as substantial debt reduction. A 1998 report from a public policy research group argued that the government's 2-year horizon "may have helped rein in the federal deficit, but it is not so well suited to the task of framing priorities for the post-deficit era, since it by definition neglects the longer-term implications of decisions made today."

Another practice that has received some criticism is the use of conservative economic assumptions. Analysts told us that they routinely discount the Finance Department's forecasts as overly pessimistic. Due to this tendency, some groups have argued that the government should adopt more realistic assumptions for its budget projections. However, other analysts continue to support the use of conservative assumptions as an acceptable way of ensuring that Canada's finances remain under control. In addition, a recent Finance Committee report suggested that recent economic developments, such as declining commodity prices and a projected slowing of economic growth, have validated the government's cautious approach. The government has recently responded to these criticisms and plans to explicitly show the impact of its "prudent" economic assumptions on its budget totals. By fully disclosing the impact of its assumptions, the government feels that there will be less debate surrounding the likely size of the surplus.

Allocation Techniques

Several analysts have criticized the way in which the government allocates surplus resources, charging that its methods obscure how much money is really available. Some cite the government's recent pattern of introducing new initiatives near the end of a fiscal year that have the effect of reducing the surplus realized in that year. For example, the government estimated that new spending and tax cuts introduced in the fiscal year 1999-2000 budget would cost CAN\$5.7 billion in fiscal year 1998-99. Along with economic and technical adjustments, these new initiatives reduced a potential fiscal year 1998-99 surplus from an estimated CAN\$11.7 billion to zero, excluding the contingency reserve. (See table 3.)

Table 3: Fiscal Outlook for Fiscal Year 1998-99

Billions of Canadian dollars

Budgetary surplus from April 1, 1998 through December 1998	\$11.7
Economic and technical adjustments	-3.2
Impact of new initiatives announced during fiscal year 1998-99	-5.5
Remaining surplus	3.0
Less contingency reserve	-3.0
Planning outcome	0

Source: *The Budget Plan 1999*, Department of Finance of Canada, February 1999.

Several analysts are also critical of the accounting methods that the government uses for some of its new initiatives. They argue that the methods overstate deficits or understate surpluses. For example, during fiscal year 1997-98, the government announced the Millennium Scholarship Fund and booked the cost of the fund in the current year even though the fund and the expenditure were not yet authorized. This action was criticized by Canada's Auditor General,²⁴ among others. The government responded that the disputed amounts were authorized before the financial statements for the fiscal year in question were finalized.²⁵

**Alternative Views on Allocating
Budget Surpluses**

The debate over the size and duration of budget surpluses is closely tied to the debate over how to allocate them. For example, the government's position is that since the size of the surplus is uncertain, it is safer to assume that it will be small. And, since the government's budgeting horizon is limited to 2 years, it tends to avoid allocation decisions that would have a major impact on the long term. Therefore, the government prefers modest tax cuts and nonpermanent spending initiatives over more costly and longer-term commitments. In contrast, various analysts and advocates prefer spending cuts or tax increases that are both more substantial and more permanent.

²⁴ *1998 Public Accounts of Canada*, Office of the Auditor General.

²⁵ The books on each fiscal year are not closed until 6 to 7 months after the fiscal year ends.

In addition to differences over the size of surpluses, the allocation debate is about differing preferences for debt reduction, spending increases, and tax cuts. The government emphasizes a balanced approach, dividing money between the three priorities with more emphasis on spending. (See figure 24.) Others have argued for a greater focus on one or more of these priorities. To some extent, public and interest group opinion on the surplus reflects pent-up demands from the years of budgetary restraint.

Advocates of greater spending point to the large cutbacks in health care, unemployment benefits, and other social assistance programs enacted earlier in the decade. Boosting health care spending, in particular, has commanded widespread public support and has been a top priority for provincial governments and interest groups. Many have expressed concern that the cuts in federal aid to the provinces have caused substantial erosion in Canada's national health insurance program. Health Canada (the federal department of health) estimates that from 1992 through 1996 public sector spending on health dropped from 7.5 percent to 6.6 percent of GDP. In response to these concerns, the government announced in the fiscal year 1999-2000 budget that it was increasing provincial aid for health care by CAN\$11.5 billion over the next 5 years. However, critics have stated that this amount is still insufficient to cover the system's growing funding needs.

Similarly, tax cut supporters, including the business community and a number of economic analysts, have characterized the government's tax relief initiatives as inadequate. They point out that Canada has a high tax burden, which makes it difficult for its businesses to compete. More specifically, they note that Canada's taxes are significantly higher than taxes in the United States, which poses a potential problem for Canada's economic competitiveness.

Several of those who support tax cuts also favor a more aggressive approach to debt reduction. According to the Finance Department, the government's current fiscal plans would reduce the debt to GDP ratio from about 68 percent at the end of fiscal year 1997-98 to about 55.5 percent in fiscal year 2002-03, assuming nominal economic growth averages 3.5 percent annually and the contingency reserve is available to pay down the debt. Several analysts and organizations that we spoke with would like debt reduction to occur at a faster pace. Some cited the lack of budgetary flexibility caused by the federal government's large interest burden and vulnerability to higher interest rates.

To help support a policy of debt reduction, several analysts suggest that the government adopt debt to GDP targets to replace or complement the fiscal targets that have been used successfully since the mid-1990s. Suggested targets vary from 40 to 60 percent of GDP. Five provinces and one territory have fiscal rules concerning debt. While some of these fiscal rules are more stringent than others, they reveal a focus on debt and the need to reduce or at least stabilize it.

Canada Faces Long-term Demographic Pressures

Like many other industrial nations, Canada faces an aging population due to a baby boom generation and increasing longevity. According to Statistics Canada, the agency that collects statistics on Canada's society and economy, the ratio of the population that is 65 and over to those aged 20 through 64 will nearly double from 20 percent in 1998 to over 38 percent by 2031.

Long-term fiscal analysis does not have any formal role in Canada's budget process as the Finance Department does not publish detailed budget projections beyond 2 years. However, federal officials and analysts are concerned about longer-term issues. For example, regular long-term projections are prepared for the Canadian Pension Plan (CPP), and these projections were used to help support a recent reform of the system.²⁶

²⁶The Canada Pension Plan law requires that an actuarial report be prepared every 3 years to allow for a review of CPP's contribution rates. The most recent report was issued in December 1998 and includes projections of CPP revenue and spending up to the year 2100.

Going beyond an analysis of particular programs, Canada's Office of the Auditor General (OAG) has looked at the broader fiscal implications of long-term spending trends. As part of its annual report to Parliament in 1998, OAG looked out three decades into the future to assess the fiscal implications of demographic pressures using illustrative simulations for spending and revenues.²⁷ OAG found that, absent any policy changes, spending on retirement income programs and health care is expected to grow much faster than the economy in coming decades—rising from around 12 percent of GDP in 1996 to about 17 percent of GDP in 2031 using the mid-range assumption for growth in health spending.²⁸ Such dramatic growth would cause significant pressure to reduce all other spending, assuming that the government chose to keep the debt burden stable. OAG's simulations showed that devoting at least a portion of budget surpluses to debt reduction over the next decade could help alleviate some of this pressure by shrinking the burden of interest spending.

Reforming Canada's Retirement Income and Health Care Programs

In 1997, Canada announced a major reform of CPP that is designed to build up a substantial reserve in what had been a largely pay-as-you-go system. The changes include a substantial increase in payroll tax rates, benefit reductions, and a plan for investing some of CPP's reserves in higher yielding assets, such as equities. Several analysts we interviewed were largely supportive of the CPP reform and some noted that the government effectively built support for this reform through a period of public consultations and education. Since CPP is separate from the rest of the federal budget, debates over reforming the program generally do not become entangled in other budgetary issues as they often do in the United States.

While the CPP reform has been successful, a recent government proposal for reforming the government's existing retirement income programs, the OAS and GIS programs, was dropped last year in response to opposition from fiscal analysts and interest groups. Analysts we interviewed said that critics of the proposal expressed concern that it would have created significant disincentives for middle income people to save for retirement by

²⁷ *Report of the Auditor General of Canada*, (April 1998), Chapter 6, "Population Aging and Information for Parliament: Understanding the Choices."

²⁸ Health care spending in the OAG study includes all levels of government in Canada. The OAG produced three different simulations for growth in health care spending: low cost, medium cost, and high cost.

requiring beneficiaries to give back a substantial portion of future benefits as their income levels increased.

In the OAG's 1998 report, two of three health cost projections showed health spending rising considerably faster than GDP in the coming decades. The third projection—a cost-containment scenario—shows health spending rising in absolute terms and growing at about the same rate as projected GDP. However, recent debate about healthcare has focused on restoring health care funding following the years of spending cuts that were part of the government's deficit reduction efforts.

Conclusion

To support a successful policy of fiscal restraint begun in the mid-1990s, the Canadian government has relied on cautious budgeting practices that have allowed it to regularly exceed its fiscal goals. Having succeeded in eliminating the deficit, the government's current goal is "balance or better." As the budget has come into surplus, the government has maintained its cautious planning practices and has adopted a similarly cautious approach to allocating budget surpluses. This allocation strategy, which reserves a portion of surpluses for debt reduction, is based on a philosophy under which the government waits until surpluses are apparent before introducing new initiatives. Critics have argued that the government's careful planning approach amounts to a policy of "stealth surpluses" that makes it difficult to conduct a full-scale public debate over how to use surpluses. Despite the criticisms, the federal government's cautious approach has been adopted by many of the provinces, whose combined deficits decreased from 2.8 percent of GDP in 1993-94 to only 0.4 percent of GDP in 1997-98.

New Zealand

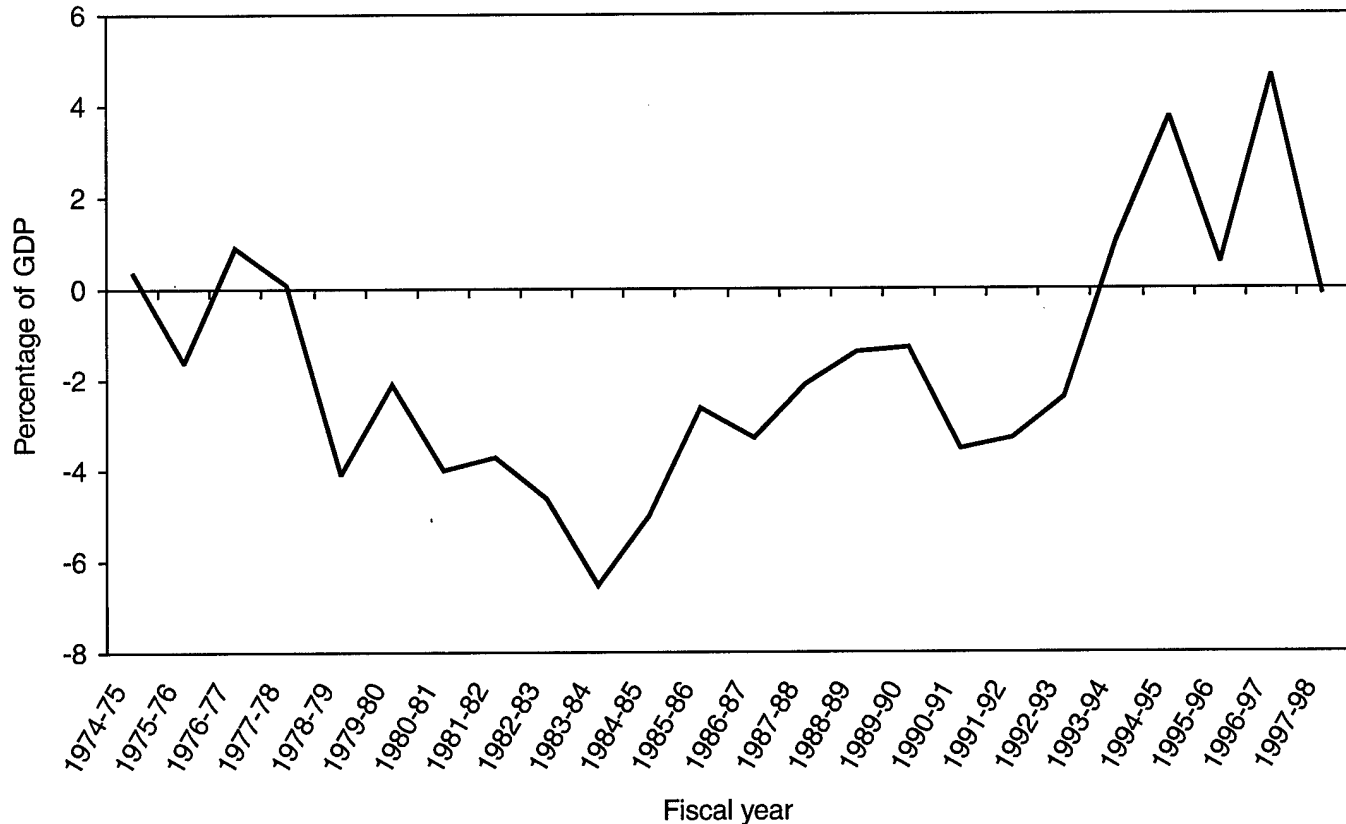
After almost two decades of deficits, New Zealand has experienced 6 years of surpluses since fiscal year 1993-94.¹ The initial drive toward surplus began in 1984 when the newly elected Labor government faced, upon election, an impending economic crisis marked by heavy capital outflows, which precipitated a large exchange rate devaluation, a credit downgrade, high inflation, and high debt. In response, the government implemented a series of sweeping economic reforms. In addition, the government undertook comprehensive public sector reforms that reduced the role of the government in the economy. During this period, fiscal restraint played an important role and was supported across the political spectrum. The Labor government attempted to address a deficit of 6.5 percent of gross domestic product (GDP) by increasing taxes and cutting expenditures in some areas, such as assistance to industries, while increasing expenditures in social programs, such as housing and education assistance to low-income earners. However, in 1990, when Labor left office, the budget was still in deficit, and net debt had grown to 50 percent of GDP.²

In 1990, a newly elected National government embarked on a program of increased fiscal restraint, targeting mainly social expenditures. However, a recession in the early 1990s led to large budget deficits that increased net debt to 52 percent of GDP in 1992. The continuation of the government's deficit reduction program, combined with a strengthening economy, led to surpluses beginning in fiscal year 1993-94. (See figure 25.)

¹New Zealand's fiscal year runs from July 1 through June 30.

²Net debt is defined as gross debt owed to the public offset by similar financial assets of the New Zealand government.

Figure 25: Budgetary Balance in New Zealand, 1974-75 to 1997-98



Note: In 1994, the New Zealand government changed its definition of surpluses/deficits from a adjusted financial balance (cash) basis to an operating balance basis, and no longer reported its operations on an adjusted financial balance basis. The budgetary balances from fiscal years 1994-95 through 1997-98 are derived by making adjustments to cash flows from operations to approximate the cash basis.

Source: New Zealand Treasury.

As surpluses materialized, the government introduced a new framework for developing fiscal policy called the Fiscal Responsibility Act (FRA) of 1994. FRA has played a critical role in guiding fiscal policy in times of surplus. Specifically, FRA laid out a set of guiding principles for fiscal decision-making. FRA also set out reporting requirements aimed at improving fiscal performance while increasing transparency and accountability. Using this framework, the National government established a fiscal policy aimed at reducing debt by running surpluses. Specifically, the

government promised to defer tax cuts until net debt was reduced to between 20 and 30 percent of GDP. In 1996, once the 30 percent target was achieved, the government reduced the debt target to 20 percent of GDP, while still allowing for some spending increases and tax cuts. Setting a debt target played a critical role in the government's ability to maintain fiscal discipline. In May 1998, the government articulated a new fiscal goal of running surpluses to reduce net debt below 15 percent of GDP.

Background

New Zealand has a unicameral parliamentary system with 120 members elected for 3-year terms through general elections. The executive government of New Zealand is composed of the Governor General and the Cabinet.³ The Cabinet consists of the Prime Minister, the Deputy Prime Minister, and other Ministers chosen from elected members of Parliament. The Cabinet has the power to make administrative or regulatory changes without further public input or legislative approval where this power has been delegated by Parliament. These changes are simply announced before implementation.

During the 1990s, New Zealand's electoral system underwent significant reform. Prior to the 1996 election, New Zealand had a "first-past-the-post" system, in which the political party that won the most votes in an electoral region won the electoral seat. Parties that gained a majority of the electoral seats formed the government and provided the Prime Minister. Under a "first-past-the-post" system two major parties controlled the government while smaller parties found it difficult to obtain representation. From 1984 through 1990, the Labor Party was in power. From late 1990 through 1996, the New Zealand National Party, representing more conservative constituencies, controlled the government.

³The Governor General is the Queen's representative. He/she does not actively participate in government, but acts on the recommendation of the government.

The electoral system changed significantly in 1993 when New Zealand voted for a "mixed member proportional" (MMP) system of representation. The MMP system was put in place in part to address concerns that minority views were underrepresented in a "first-past-the-post" system. Under MMP, voters cast two ballots: one for members of Parliament and one for the party. Around half of the 120 members of Parliament are elected directly as representatives of their district, while the remaining members are chosen by the parties in proportion to the percentage of the overall party vote received in the election. The outcome of the new system is that smaller parties are now able to gain more seats. In 1996, the first year under the new MMP system, the National Party won 44 out of 120 seats and entered into an agreement with the New Zealand First Party (17 seats) to form a coalition government. In August 1998, the coalition dissolved and was replaced by a minority government led by the National Party.⁴

The New Zealand Economy

New Zealand is a small economy that is dependent on trade—its GDP is less than 1 percent the size of the U.S. economy and exports account for nearly 22 percent of GDP, compared to about 9 percent for the U.S. in 1997.

Recent Economic History

Until the early 1980s, New Zealand was one of the most regulated of the developed economies. New Zealand heavily subsidized its industries, with the agricultural sector receiving price supports and tax concessions, and the manufacturing sector benefiting from import licensing and tariffs. The government provided a fairly comprehensive and generous package of social programs, including pensions for the elderly, benefits for single parents and mothers, universal health care, and policies that ensured full employment. The government also played a large, direct role in the economy, with a major presence in industries such as telecommunications, banking, energy, forestry, transport, and broadcasting services that together produced more than 12 percent of GDP.

New Zealand has traditionally been heavily dependent on trade for economic growth. In 1997, exports of goods and services totaled 22 percent of GDP. Until the mid-1980s, New Zealand relied heavily on the United Kingdom as a market for its exports, which were mostly agricultural

⁴A minority government can remain in power so long as it can survive a vote of no confidence, or until another coalition with more votes is formed. If a majority of the members of Parliament vote no confidence in the government, then an election must be held.

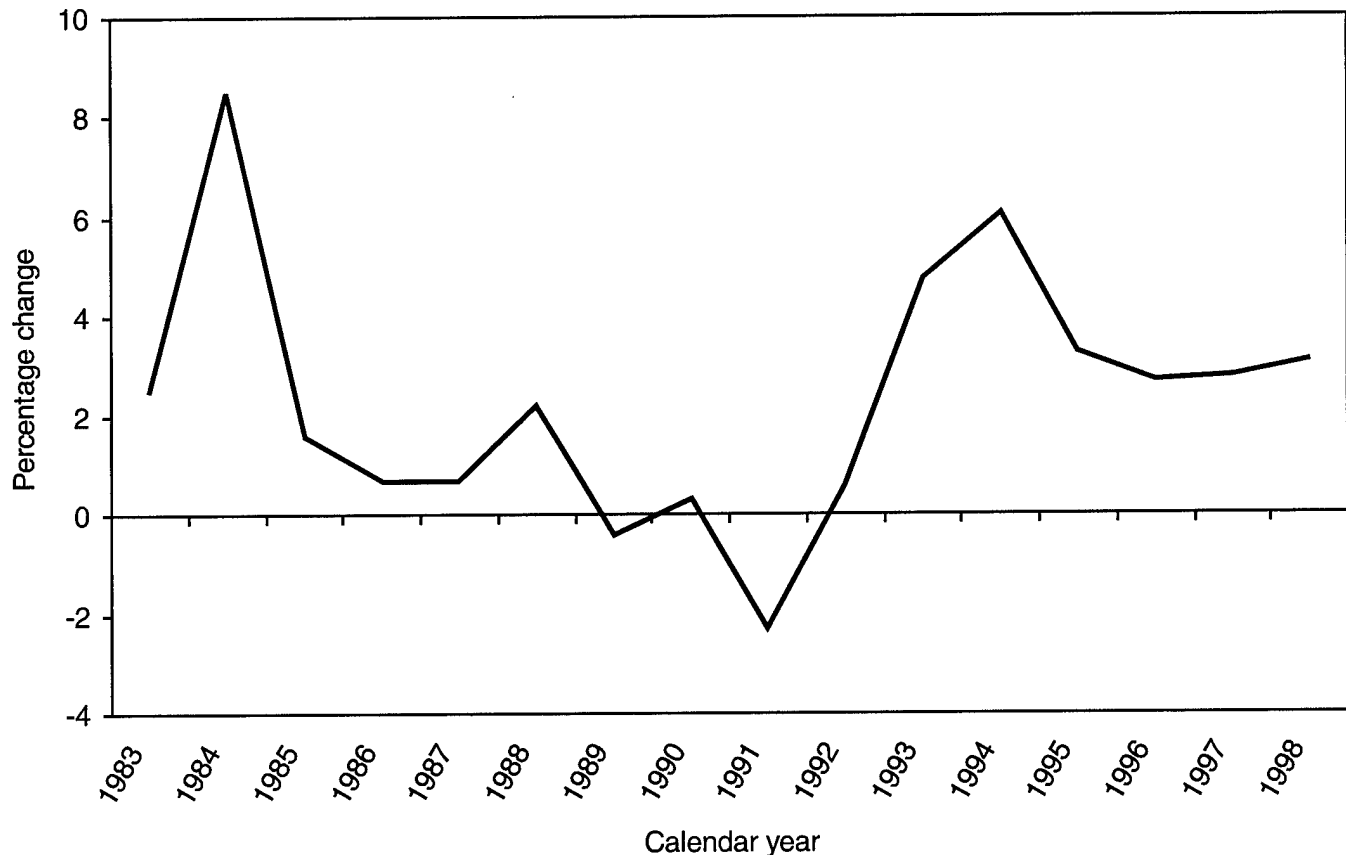
products. The United Kingdom's entrance into the European Common Market in 1973 opened the British market up to goods from European Union countries but denied New Zealand easy access to its traditional major export market.

In addition to losing the United Kingdom as a protected market for agricultural exports, New Zealand was also affected by two world oil price shocks in the 1970s. The government responded by increasing taxes, devaluing the currency, and implementing programs such as state-funded investments aimed at cushioning the economy from these international shocks. One such response was "Think Big," a program designed to improve New Zealand's production of energy, thereby reducing its reliance on external energy sources. Contrary to the government's expectations, these initiatives led to increased debt, fiscal constraints, and higher interest rates. Economic growth remained low: from 1975 through 1982 there was virtually no growth, while inflation averaged about 15 percent per year. During this period, unemployment emerged as a serious problem, rising from less than 1 percent to more than 5 percent in 1983. Furthermore, large fiscal deficits emerged in the late 1970s, and foreign debt rose rapidly as a result of large external deficits. By the early 1980s, economic performance as measured by a wide range of indicators—growth, unemployment, inflation, and the external deficit—had deteriorated substantially.

In response to the deteriorating economic and fiscal conditions, the new Labor government in July 1984 began to institute a series of sweeping reforms that by the end of its term in 1990 had transformed the country from one of the most to one of the least regulated economies. However, economic benefits did not materialize until the 1990s. In 1991, after 7 years of reform, real GDP was only 2.8 percent higher than in 1984 compared to an average of 24 percent for Organization for Economic Cooperation and Development (OECD) member countries in the same period. Unemployment also grew during this period, peaking at almost 11 percent in September 1991, up from less than 5 percent in the early 1980s.

Strong export-driven growth began in 1991, and the economy grew at an annual average rate of 3.5 percent from 1991 through 1997. From June 1995 through December 1996, unemployment dropped to a low of around 6 percent. Since 1996, growth has slowed, as shown in figure 26, and unemployment increased to 7.7 percent in December 1998. More recently, the Asian economic downturn and drought conditions have negatively affected the country's growth rate.

Figure 26: GDP Growth in New Zealand, 1983 to 1998



Source: *OECD Economic Outlook* 63, June 1998.

Economic changes in the 1990s can be linked, in part, to a change in monetary policy. In 1989, New Zealand passed the Reserve Bank of New Zealand Act that assigns a single role for monetary policy: to achieve and maintain price stability. Prior to the act, monetary policy focused on ensuring the stability of the economy, maintaining full employment, and increasing economic growth. The act requires a written agreement between the Treasurer and the Governor of the Reserve Bank that defines and makes public the specific targets for price stability.

The Governor of the Reserve Bank believes that the stable inflation policy has contributed to the strong fiscal performance by offsetting, or

threatening to offset, expansionary fiscal policies. For example, in response to an expansionary budget introduced during the 1990 election year, the bank tightened monetary policy. In 1996, the government reduced income tax rates only after it was satisfied that such tax cuts would not result in a significant tightening of monetary policy.

Budget Process

The government, through the Treasury, is responsible for developing the budget and presenting it to Parliament. The process starts with the government releasing its policy statement setting forth its vision and the strategic objectives for the fiscal year and the coming 3 years. After the release of the policy statement, departments submit bids for new program initiatives. Bids are reviewed by the Cabinet on advice from Treasury, and those that fit with strategic objectives can receive new funding. In May or June, the government submits a budget that has to fulfill the strategic objectives announced in the policy statement or provides explanations or justifications for inconsistencies. By that time, the government has decided which new programs and policy actions to fund.

Under this process, most budget deliberations and the approval of new policy actions take place prior to the public presentation of the budget. After the budget is presented to Parliament, select committees examine the budget, question ministers and departments about their budget requests, and may propose changes to appropriations. However, in general, government budgets are passed without many changes. Failure to pass a budget would result in the dissolution of the government and probably a new election.

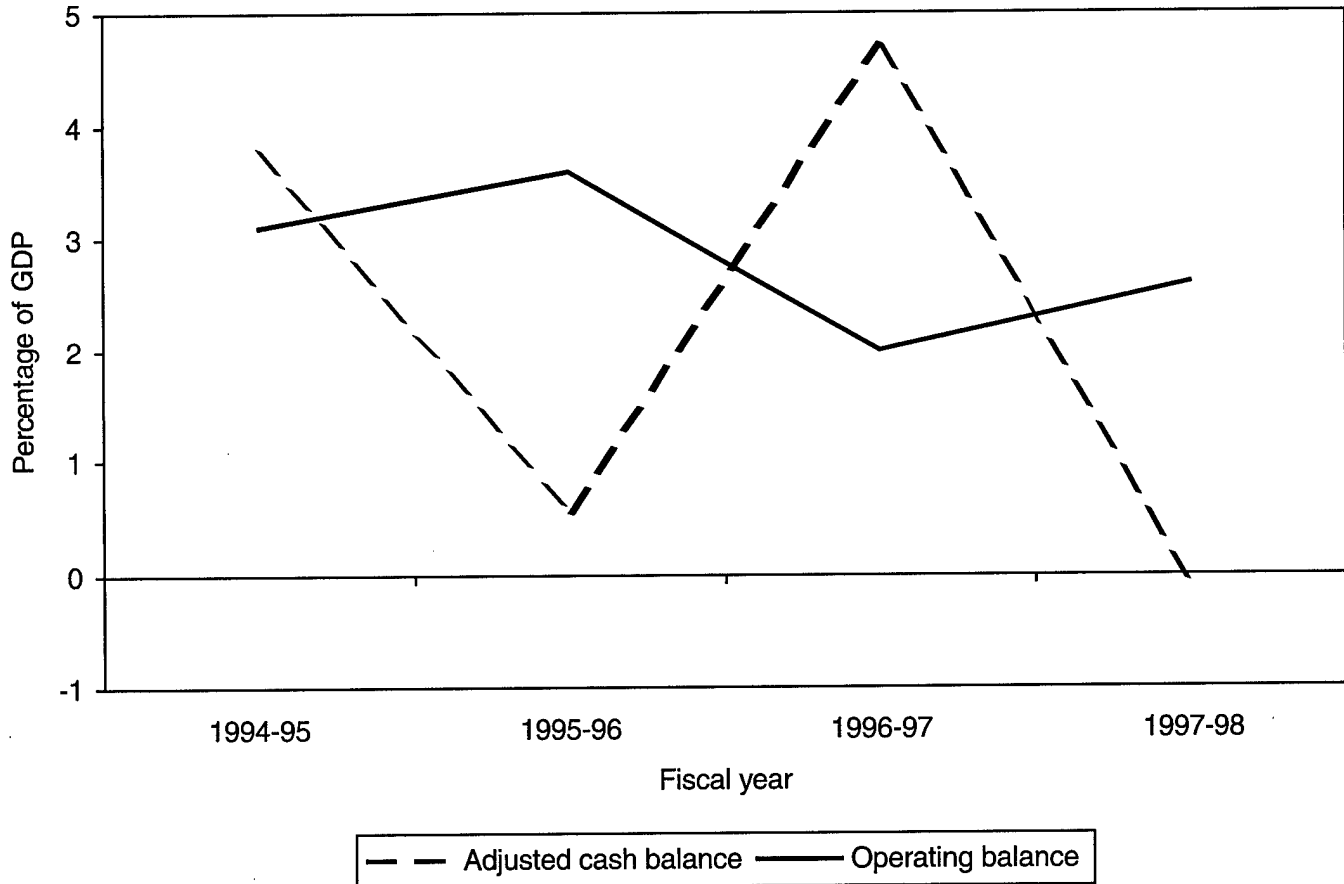
Measuring Fiscal Position

Prior to 1994, New Zealand's surplus/deficit was a cash number, similar to the unified budget figure used in the United States. Revenue and expenditures, including capital expenditures, were recorded when cash was actually received or spent. Consequently, the surplus/deficit measure encompassed all receipts and expenditures.

In 1994, New Zealand became the first OECD country to use an accrual-based measure of fiscal position.⁵ The measure, called the operating balance, is designed to match more closely the cost of resources consumed in the production of goods and services with the revenues. As part of this change, departments no longer record an expenditure when an asset is purchased. Rather, a depreciation expense is recorded when the asset is used. Another important change is that the government records the cost of liabilities when the events that give rise to these liabilities occur. For example, the cost of providing public employee pensions is recorded at the time the employee works, rather than when the employee has claim on the cash. This method of recognizing liabilities differs from the approach taken under the cash basis, under which the cost is recognized only when a cash outlay occurs. The net effect of the differences between the operating balance—the primary measure of fiscal position—and the cash balance is shown in figure 27.

⁵The Public Finance Act of 1989 first required the use of accrual budgeting at the department level. In 1994, the government enacted FRA, which reaffirmed its commitment to greater accountability and transparency in government through improved financial management and devolution of responsibilities. FRA endorses the move to accrual as necessary to the new fiscal environment and requires that the government as a whole budget on an accrual basis.

Figure 27: Comparison Between Adjusted Cash and Operating Balances in New Zealand, 1994-95 to 1997-98



Note: In 1994, the New Zealand government changed its definition of surpluses/deficits from an adjusted financial balance (cash) basis to an operating balance basis and no longer reported its deficit/surplus on a cash basis. The adjusted cash balances from fiscal years 1994-95 through 1997-98 are GAO calculations. They reflect adjustments made to the cash flows from operations, which approximate the adjusted financial balance used to measure surpluses/deficits prior to 1994. However, some additional adjustments are necessary to arrive at an exact measure of the adjusted financial balance as reported prior to 1994.

Source: New Zealand Treasury.

Government officials and experts we met with felt that accrual measures of deficits/surpluses better reflect the ongoing health of the government than pure cash measures. They stated that by recognizing employee pension costs, accrual data give a better picture of the cost and obligations of government policies. Also, by excluding privatization proceeds that are

one-time-only transactions that cannot be expected to occur again in the future, the new measure better reflects the ongoing performance of government. Finally, by requiring recognition of the long-term cost of decisions, accrual measures make clear the full cost of spending decisions that have minimal effects today but greatly affect future budgets. For example, in the 1970s, the government did not recognize the cost of establishing guarantee programs for energy projects. In the late 1980s, the guarantee costs totaled more than NZ\$6 billion, or more than 10 percent of GDP. According to an ex-finance official, under accrual such costs would have been recognized over the years and such a large delayed charge to the budget would not have occurred. Had the full cost of such decisions been made available, commitments with large deferred costs may not have been made. However, New Zealand does not include the commitment of its social security system in its accrual-based measures because these commitments (1) can be changed by acts of Parliament, and (2) cannot be reliably estimated and, therefore, do not meet the criteria, as defined by generally accepted accounting practice, for recognition as a liability.

In addition to the operating balance, New Zealand also emphasizes the debt to GDP ratio as a key indicator to track the government's performance in the economy. The government articulated the need for New Zealand, as a nation with a small and open economy, to maintain a low debt to GDP ratio in order to be better able to respond to economic shocks. Officials and experts we interviewed explained that setting debt targets was a necessary first step in determining the operating balance and articulating the necessity for operating surpluses. These officials felt that the use of the debt to GDP ratio was a critical factor in keeping the government on track towards surpluses in order to pay down debt.

Fiscal Policy of the Mid-1980s Driven by the Desire to Reduce the Government's Role in the Economy

As shown earlier in figure 25, New Zealand had large deficits extending back to the late 1970s. The deficits were large, exceeding 2 percent of GDP in all years before 1984. The deficits were caused in part by government actions taken to implement fiscal policies that sought to counter the effects of a weak economy through expansionary policies. These policies, which were financed largely through additional borrowing from abroad, led to a sharp deterioration in the fiscal position. By 1984, the ratio of government expenditure to GDP was more than 38 percent, and the deficit was 6.5 percent of GDP. Thus, deficit reduction efforts in New Zealand beginning in 1984 were aimed at reforming the economy and reducing the size of the public sector.

Economic and Public Sector Reform

The New Zealand economy in the late 1970s and early 1980s was marked by a major government presence in many sectors of the economy and extensive government intervention in the economy. However, from 1975 through 1982, the New Zealand economy experienced virtually no growth, while inflation averaged about 15 percent per year and unemployment, which had never risen beyond 1 percent, reached a peak of over 5 percent in 1983. A loss of investor confidence led to heavy capital outflows, which precipitated a large currency crisis. Thus, in the early 1980s, the New Zealand economy was marked by serious problems.

The impending economic crisis prompted the Labor government that came to power in 1984 to take decisive actions. The primary goal of the new government was to introduce more openness and competition—which the reformers saw as the primary engines for economic growth—into the highly controlled economy. From 1984 through 1990, the government focused its efforts primarily on reforming the economy to improve its performance and restore investor confidence, while deficit reduction played a supporting role. Specifically, in 1984 the new government devalued the currency by 20 percent and then allowed its value to float on the open market, opened up the financial markets to international competition and investment, and deregulated major sectors of the economy. The government also removed wage and price controls and reduced or eliminated subsidies for many industries.

Along with economic reforms, the government implemented many reforms that resulted in a smaller public sector. It began by corporatizing government departments engaged in commercial activities into state-owned enterprises and putting them on a commercial basis. In many instances, these enterprises had to adopt business practices and compete with private sector enterprises. From 1986 through 1990, many of these state-owned enterprises were privatized. By 1994, privatization and other initiatives aimed at improving economic and government performance had reduced the number of public sector employees to less than half the 1984 level.

In addition, the government passed several laws changing the focus of government management and budgeting. The Public Finance Act of 1989 required the use of accrual budgeting while the State Sector Act of 1988 shifted responsibility for managing inputs, such as the number of employees, from central control to department managers. The acts gave these managers more latitude in purchasing and hiring decisions in

exchange for the delivery of outputs such as serving a specific number of welfare recipients.

Deficit Reduction Efforts

From 1984 through 1990, deficit reduction was achieved mainly through increases in revenues. In October 1986, the government introduced a broad-based 10 percent Goods and Services Tax (GST), part of a general effort to move the tax burden from direct taxes such as income taxes to indirect taxes such as GST.⁶ Although there were significant cuts in the marginal personal income tax rates, these were offset somewhat by the elimination of tax loopholes and a general broadening of the tax base. As the tax brackets were not indexed for inflation and the economy grew, tax revenues increased as a share of GDP. In addition, government-owned enterprises were generating healthy surpluses, which were counted as government revenue. Taken together, the result was an increase in revenue from about 32 percent of GDP in fiscal year 1984-85 to almost 40 percent of GDP in fiscal year 1989-90.

Despite efforts to cut government spending, government expenditures as a percentage of GDP increased from less than 37 to more than 41 percent from fiscal year 1984-85 to fiscal year 1989-90. Although the government moved initially to reduce or abolish subsidies and restrain spending in most program areas, these cuts were more than offset by growth in expenditures in social welfare, health, and education that together made up more than 55 percent of the budget in 1984. Increases in social expenditures were driven by increased demand for education and health programs. In addition, the turbulence in the economy and slow economic growth led to large increases in cyclically-sensitive claims such as unemployment. By fiscal year 1990-91, social programs had grown to about 62 percent of the budget, representing more than 25 percent of GDP and a level that was 5 percentage points higher than in fiscal year 1984-85.

Although privatization was undertaken mainly to improve economic performance, proceeds from these efforts led to a decrease in debt during the 1980s. From 1988 through the end of 1990, 15 of the largest state-owned enterprises were privatized. Privatization proceeds totaled more than NZ\$9.4 billion as of December 1990. Proceeds contributed to reduction of the gross public debt from almost 78 percent of GDP in 1987 to about 62 percent of GDP in 1990.

⁶The GST rate was subsequently increased to 12.5 percent in March 1989.

Fiscal Policy of the Early 1990s Focused on Eliminating the Deficit and Then Reducing the Debt

Beginning in late 1990, the newly elected government focused on deficit reduction. The government was unaware that it would face, upon election, a large deficit instead of a balanced budget. Furthermore, upon taking office, it became apparent that deficits would persist due to an economy that was entering a deep recession, unless policy actions were taken. In addition, New Zealand was faced with the prospect of a credit downgrade due to concerns about the state of the economy, which would cause its borrowing costs to increase. Decisionmakers became keenly aware of the need to sustain foreign investor confidence in their economic and fiscal policies.

Shortly after the election, the government presented an economic package that focused primarily on spending cuts to restore fiscal health. The package reflected the keen awareness among decisionmakers of the need to sustain foreign investor confidence in their economic and fiscal policies. Among other things, the budget retained the surcharge on superannuation (New Zealand's public pension program) that the new government had promised to abolish during the 1990 campaign. The fiscal year 1990-91 budget enacted severe cuts to social welfare benefits totaling NZ\$245 million while the fiscal year 1991-92 budget cut another NZ\$1.25 billion. The government also held spending increases to a minimum on other expenditure categories. Officials believed that such difficult decisions were necessary to turn the economy and the fiscal position around.

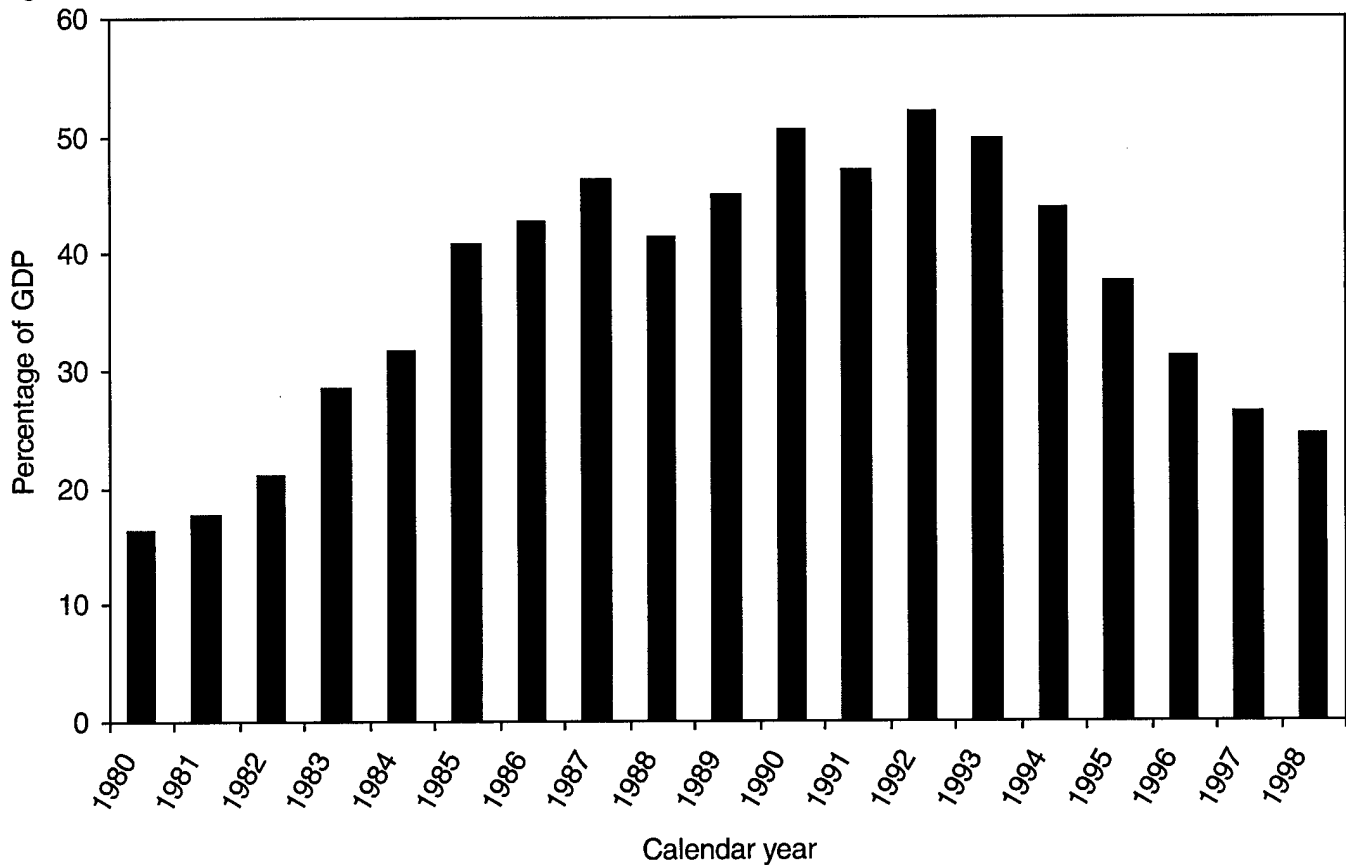
The deficit reduction program, along with an improving economy led by growth in exports, provided the impetus for New Zealand's improving fiscal position. By fiscal year 1993-94, the first year of surplus, the government had succeeded in reducing expenditures from more than 42 percent of GDP in fiscal year 1990-91 to less than 35 percent.⁷ Strong progress on constraining expenditure, together with proceeds from privatization totaling nearly NZ\$3.2 billion from 1991 through 1993, allowed the government to reduce debt.

In 1994, when it became apparent that surpluses would continue, the government articulated the need for continued surpluses in order to reduce debt. New Zealand is a small, open economy that is highly susceptible to international shocks. The government believed that a lower debt level

⁷In 1993-94, New Zealand achieved surplus in both cash and operating bases.

would improve fiscal flexibility and better prepare New Zealand for the next economic shock. Furthermore, policymakers thought that reducing debt would serve to increase the confidence of international investors in the New Zealand economy. The government's efforts have largely been successful, with public sector debt falling from over 50 percent of GDP in 1990 to a 1998 level of under 25 percent. (See figure 28.) While this is generally viewed as a significant achievement, some believe that further debt reduction will be necessary if the country is to successfully address long-term fiscal and economic issues. Currently, the government has a public sector debt goal of less than 15 percent of GDP.

Figure 28: Net Public Sector Debt in New Zealand, 1980 to 1998



Source: New Zealand Treasury.

New Zealand finance officials we interviewed credited at least part of the ability to maintain fiscal discipline to budget and accounting reforms. They stated that the government maintained departmental budgets at the same level from 1991 through 1998 unless departments could present a compelling case for increased spending. As a result, it became difficult to introduce new programs or undertake additional activities under this new approach, and most departments experienced a budget reduction in real terms, which they were expected to absorb through increased efficiency. Officials we spoke with felt that the budget and accounting reforms improved their ability to price governmental goods and services (outputs) and have helped New Zealand to make efficiency gains without a drop in the level and quality of service. For example, by requiring that departments absorb a capital charge, the government reduced the desire to acquire new capital assets and provided an incentive for selling non-performing assets.

A New Framework for Fiscal Decision-making

As noted earlier, in 1994 the government passed the FRA, which established a new framework for fiscal decision-making. FRA was developed to lead to better fiscal outcomes by making policymakers consider not only the short-term impacts of decisions but also the medium- and long-term impacts. FRA was also put in place, in part, in anticipation of the new MMP electoral system. The change to MMP was likely to lead to coalition governments. Officials feared that the compromises resulting from coalition governments would result in a deterioration of fiscal discipline. FRA was designed to make this more difficult.

FRA established five main principles for sound fiscal management. The government is required to (1) establish a prudent level for debt necessary to provide a buffer against future adverse events, then work to reduce debt to that level by achieving operating surpluses every year that the debt is above a targeted level, (2) maintain this prudent debt level once achieved by running a balanced budget on average over the economic cycle, (3) achieve a level of national net worth that would provide a buffer against adverse economic shocks, (4) pursue a policy of stable and predictable tax rates, and (5) manage the risks facing the government. The framework does not dictate specific targets for debt, surpluses, or risks, but allows the government to define its own medium-term strategies and short-term fiscal goals in such a way as to fulfill these principles.

FRA also put in place institutional arrangements designed to improve transparency in the formulation of and accountability in the performance of fiscal policies by requiring extensive reporting on these policies. Before

the budget is presented, a Budget Policy Statement must be presented that sets forth the broad strategic goals of the government. The Fiscal Strategy Report that accompanies the budget has to specify that the budget is consistent with the Budget Policy Statement or justify any departure. This report must provide fiscal scenarios covering at least the next 10 years. Other reporting requirements include the Economic and Fiscal Update at the time of the budget, a half-year Economic and Fiscal Update in December, an update with supplementary appropriations, as well as a pre-election economic and fiscal update at least 14 days before a general election. FRA also requires the government to use accrual concepts for budgeting and reporting. Finally, FRA requires the government to disclose all decisions that may have a material effect on the future fiscal and economic outlook. The government hoped that these extensive reporting requirements would ensure that departures from what are deemed the principles of responsible fiscal management would only be temporary since they would have to be reported and justified to the public.

New Zealand Aims for Sustained Surpluses

Since 1994, New Zealand's fiscal policy has been to run sustained surpluses until a desired debt level is achieved.⁸ The government cites three main reasons for running sustained surpluses and reducing debt: (1) to provide a buffer against economic shocks, (2) to deal with the significant pressures that demographic trends will place on the fiscal position in the future, and (3) to allow for lower taxes in order to increase international competitiveness and economic growth.

Most officials and experts we talked with agreed that the New Zealand economy is extremely susceptible to external economic shocks. A fallback into budget deficit is seen as undesirable because it would likely result in an adverse response by international markets. The resulting increase in interest rates would be harmful to the business sector and, ultimately, would be detrimental to the health of the economy as a whole. A budget deficit is not acceptable because concern still exists over the debt level and because future demographic pressures are becoming more apparent.

Interviewees added that the New Zealand political landscape has undergone substantial changes, to the point that running sustained

⁸The targeted net debt level was originally set at between 20 and 30 percent of GDP in the 1994 budget. The target was decreased to 20 percent of GDP in the 1995 budget and further decreased to less than 15 percent of GDP in May 1998.

surpluses is now the accepted norm of most political parties. While some interviewees, concerned about the deterioration in the national infrastructure, argued that New Zealand could assume additional debt for investment purposes, most agreed on a policy of continued surpluses. An ex-finance official argued that some consensus existed for maintaining surpluses in time of economic growth so the government could better address long-term pressure such as the aging population. According to this ex-official, the relevant question in New Zealand is not whether to maintain surpluses but rather how rigidly the policy needs to be carried out. Some opposition parties are committed to achieving surpluses over the business cycle, allowing for deficits during periods of economic weakness. However, the current government has said it is imperative to maintain surpluses until the desirable level of debt is achieved.

The fiscal year 1994-95 budget was the first in a series of budgets to operationalize the principles of FRA. A main objective of the budget was to reduce net debt to between 20 and 30 percent of GDP and achieve a debt to GDP ratio of 20 percent by 2003-04. In fiscal years 1994-95 and 1995-96—2 years after the first budget surplus was achieved—the government continued to maintain fiscally conservative policies. In 1995, the government reaffirmed its commitment to running short-term surpluses and promised to consider tax cuts only after net debt fell below 30 percent of GDP. Pointing to experience that showed that the fiscal balance could shift up or down by more than 3 percent of GDP over the cycle, the government committed itself to running surpluses of at least 3 percent of GDP in an environment of strong economic growth. In addition, the government continued its privatization programs. Proceeds from privatization, as well as cash made available from operating surpluses, were dedicated to debt reduction, resulting in substantial progress towards achieving the 30 percent debt goal.⁹

As a result of the increasing revenues and decreasing expenditures, New Zealand ran operating surpluses averaging almost 3 percent of GDP from fiscal years 1994-95 through 1997-98. Despite the fact that the government did not actively increase taxes during the mid-1990s, revenues increased as a percent of GDP during this period for several non-policy related reasons.

⁹The full cash value of privatization proceeds is not included in the operating balance. Under an accrual basis, only gains or losses are recorded in the operating balance. A gain would occur if the sale price was above the net asset value, and a loss would occur if the sale price was below the net asset value. However, all of the cash from the asset sale is available for debt reduction.

Tax receipts increased because New Zealand's taxes are not indexed to inflation and corporate profits grew with the improving economy. In fiscal year 1995-96, taxes and other revenues accounted for more than 38 percent of GDP, an increase from 36.6 percent in fiscal year 1993-94. On the expenditure side, the government held the line on nominal increases, so that by fiscal year 1995-96, expenditures as a share of GDP decreased to approximately 34.5 percent, from 36 percent in fiscal year 1993-94.

Once the government's debt level goals were reached, the government both lowered the targets and passed budgets with tax cuts and increased expenditures. In 1996, as the debt level was estimated to reach the initial target of 30 percent of GDP, the government enacted a new budget that aimed to reduce debt to below 20 percent of GDP while making room for reduction in taxes. The 1996 tax cut package consisted of a two-stage reduction in the income tax rate planned for 1996 and 1997. The package, which went into effect July 1, 1996, totaled more than NZ\$7 billion over 3 years and, along with smaller measures, reduced revenues from more than 38 percent of GDP in fiscal year 1995-96 to a fiscal year 1998-99 estimated level of less than 35 percent. While the budget also targeted specific areas such as health and education for spending increases, the growth in expenditures was relatively small.

As mentioned previously, the 1996 election resulted in the formation of a coalition government in New Zealand. The coalition government supported spending initiatives that were not included in the fiscal year 1996-97 budget. In response to these pressures, the government passed a NZ\$5 billion spending package to be phased in over 3 fiscal years starting with fiscal year 1997-98. The spending package allocated additional funding to health and education and abolished the superannuation surcharge to fulfill a 1990 campaign promise. To mitigate the fiscal pressure and reaffirm its commitment towards surpluses, the government postponed the second round of tax cuts until July 1, 1998, citing as reasons slowing economic conditions and reduced projected surpluses.

Despite actions taken to reduce taxes and increase expenditures, reducing net debt is still the overriding objective of fiscal policy. In 1998, the government once again changed its target for debt to less than 15 percent of GDP and planned to run surpluses until this level of debt was achieved. In response to the Asian downturn and a forecasted fallback into deficit, the government agreed in May 1998 to set aside NZ\$300 million of the NZ\$5 billion spending package to bolster operating surpluses, thus effectively reducing spending by NZ\$150 million in fiscal years 1998-99 and

1999-2000. In July 1998, the government once again reduced NZ\$300 million from the spending package, thus lowering funding for policy initiatives to NZ\$4.4 billion over the next 3 years. In September 1998, the government launched yet another program to cut NZ\$150 million in expenditure that contained, among other provisions, a continuation of government policy to index old-age pension benefits to prices instead of wages until benefits reach 60 percent of average wage. According to an ex-official we interviewed, this was a difficult and controversial decision because it reduced the potential increases in benefits, but it was necessary if the government wanted to adhere to its debt reduction policy. Most recently, the government forecast that its budget would be in balance for fiscal year 1999-2000, before achieving surpluses again starting with fiscal year 2000-01.

Long-term Pressures and Reforms

Like many other industrial nations, New Zealand faces the fiscal pressures associated with an aging population. The proportion of the population aged 65 and over is projected to increase by more than 75 percent between 1996 and 2031, from about 12 percent to 21 percent of the population. About the same time, the ratio of workers to retirees is projected to decrease from 5.8 to 3.4 workers per retiree. The growth in the elderly population is forecast to impose extensive pressure on New Zealand's fiscal position. Because the benefits are fairly generous and because beneficiaries are not subject to either asset or explicit income tests to qualify for benefits, old-age pensions are forecast to almost double as a share of GDP from a current level of more than 5 percent of GDP.

The government has made temporary changes to pension provisions, such as imposing a surcharge on high-income earners (subsequently repealed) and indexing old-age pension to prices rather than wages. In 1991, the government raised the eligibility age for pensions from 60 to 65 over a 10-year period from 1991 through 2001. However, these changes have not fully addressed the large projected increases in pension expenditures. In an attempt to improve the long-term fiscal balance, the government in 1997 designed a compulsory savings scheme that was submitted to a public referendum, but it was overwhelmingly rejected. Officials that we spoke with said they thought this outcome had deferred pension reform discussions for the time being.

According to officials, the health system also presents numerous challenges to reformers. The system is primarily a public system, supplemented by private insurance and out-of-pocket copayments for

general practitioners and pharmaceuticals and for surgical procedures that would otherwise not be available immediately. Since the 1980s, health care expenditures have shifted to the private sector, with their share of total health expenditures increasing from 12 percent in fiscal year 1979-80 to almost 23 percent in fiscal year 1996-97. Despite the expenditure shift and other government actions to reform this area, government health expenditure continued to average around 5 to 6 percent of GDP, below the average of other developed nations. The growth in the elderly population is forecast to almost double health care costs from fiscal year 1997-98 through the year 2050.

Conclusion

New Zealand began on the road to surpluses and lower debt by first addressing economic fundamentals and undertaking reforms of the public sector that included substantial privatization of government enterprises. In the 1980s, proceeds from privatization and increased tax revenues allowed the government to pay down debt and support large increases in social expenditures. In the 1990s, the government began a deficit reduction period that was marked by a focus on holding the line on expenditures. The government further enforced fiscal discipline by putting in place a new framework that focused fiscal policies on achieving prudent debt levels. By focusing on the debt to GDP ratio, the government was able to justify the need to run surpluses for several years. Upon achieving its initial goal of a net debt level from 20 to 30 percent of GDP, the government enacted a package of tax cuts. Subsequently, the government has set even lower levels of debt and confirmed surpluses as its primary goal, while allowing for increased spending in priority areas.

Norway

Norway has achieved budget surpluses on a general government basis in all but two—1992 and 1993—of the last 50 years.¹ Generally throughout the post-war period, running budget surpluses was the aim of the government in power. Since the early 1970s, surpluses have increasingly been the result of a rapid increase in revenues from the oil industry. A large and growing oil industry has had a dramatic impact not only on the budget but also on the Norwegian economy. Norway has generally enjoyed strong economic growth during the past 25 years as a result of its petroleum industry. However, beginning with an oil price collapse in late 1985, Norway experienced a prolonged economic slowdown, which by the early 1990s resulted in record high unemployment and a return of budget deficits for the first time in nearly 50 years.

Decisionmakers responded with a series of reforms aimed to improve the long-term fiscal and economic health of the country. In 1993, the government entered into an agreement with labor and business leaders with the stated goal of achieving long-term economic growth, high employment, low inflation, and a stable exchange rate. The government agreed to focus fiscal policy on stabilizing the economy, while monetary policy would focus on stabilizing the currency. Labor and business leaders agreed to hold down wage increases, reducing inflationary pressures in the economy. Officials we spoke with felt that these reforms have played a critical role in the turnaround of the economy and the return to surpluses. Figure 29 shows Norway's general government financial balance as a percentage of GDP from 1970 to 1998.

¹A general government basis includes the fiscal position of subnational levels of government and public pension funds.

Figure 29: General Government Financial Balance as a Percent of GDP in Norway, 1970 to 1998



Source: OECD Economic Outlook 65, June 1999.

Upon achieving surpluses, the government has adopted a long-term focus for fiscal policy—attempting to save surpluses to deal with future budget pressures. Specifically, Norway projects a sharp rise in public pension expenditures and a corresponding decrease in petroleum revenues. The government has decided that it needs to accumulate financial wealth to help pay for these pressures, and since 1996 has deposited budget surpluses in the Government Petroleum Fund. To further support continued fiscal discipline, the Parliament reformed its budget process in 1997, putting in place expenditure and revenue ceilings for the first time. However, the ability of the government to maintain fiscal discipline during a period of surplus came under increasing pressure. A minority coalition

government was formed in 1997, and it increased spending above the previous government's proposals. A tight labor market, a sharp drop in oil prices, and turbulence in currency markets have, together, placed increasing strain on the government's ability to maintain fiscal discipline.

Background

Norway is a constitutional monarchy with a parliamentary system of government.² The Parliament, called the Storting, is composed of two chambers with a total of 165 members. The government is headed by the Prime Minister and a Cabinet of 19 ministers. The governing party or coalition of parties must be backed by a majority of Parliament but need not constitute a majority of Parliament. The government is responsible for most legislation, but individual members of Parliament may introduce bills. Each year, the government prepares and introduces the budget to Parliament. Parliament has final authority over all budget matters and in practice often changes the government's proposals.

Elections are held every 4 years, and a new election may not be called outside this cycle. If the government receives a no confidence vote or resigns, then a new government must form from the current Parliament. Norway has a system of proportional representation with the number of representatives of each party determined roughly in proportion to the votes the party receives in the election.³

Since 1945, the left-of-center Labor party has dominated Norwegian politics, holding government for all but 16 years. From 1945 until 1961, the Labor party held a majority of seats. Since 1961, power has alternated between coalition governments and minority Labor governments, with the Conservative party holding power from 1981 to 1983.

²In practice, the King accepts the will of Parliament and functions in a largely ceremonial role.

³There is some discrepancy between the popular vote and the makeup of Parliament. Norway's electoral system is weighted to give more sparsely populated areas more representation. Also, seats for Parliament are allocated by electoral district, and as a result some smaller parties may not get enough votes to receive a seat. To compensate for this, Norway added eight nationwide seats to Parliament in 1989, to be awarded to parties so that the makeup of Parliament more closely approximates the election results.

Currently, Prime Minister Kjell Magne Bondevik is leader of a minority coalition government. He became Prime Minister following the 1997 election when a centrist coalition made up of the Christian Democrats (Mr. Bondevik's party), the Centre party, and the Liberal party formed the government. The coalition government took over after the Labor party stepped down following a poorer than expected showing in the 1997 election, despite the fact that Labor holds a higher percentage of seats with 35 percent than the coalition with 26 percent.⁴

Economy

The Norwegian economy is about 2 percent the size of the U.S. economy and heavily dependent on foreign trade. In 1997, exports accounted for about 41 percent of GDP. Norwegian industry has traditionally been raw-material based. The discovery of oil in the late 1960s has had a profound effect on the Norwegian economy, and the petroleum sector has grown rapidly to account for about 20 percent of the economy and about one half of total merchandise exports.

Recent Economic History

Since the 1970s, Norway's economic performance has been heavily influenced by its rapidly growing oil industry. However, as a result, the Norwegian economy has become subject to increasingly volatile swings in oil prices and production. For example, Norway experienced a period of strong economic growth in the mid-1970s as a result of high oil prices and increased oil production, which was followed by a period of slow growth in the early 1980s. Then, in the mid-1980s, Norway experienced a short but strong economic boom, which was brought on by expansionary fiscal and monetary policies and a sharp increase in the availability of consumer credit. From 1986 to 1992, Norway experienced its longest economic downturn since World War II, which was precipitated by a sharp drop in world oil prices. The slowdown continued through the late 1980s as the government maintained its tight fiscal policy stance in an attempt to reduce inflationary pressures and because consumer spending slowed in reaction to the sharp run-up in borrowing during the mid-1980s and the increased cost of borrowing.

In reaction to rising unemployment, the government adopted an expansionary fiscal stance beginning in 1989, but the economy did not begin its turnaround until 1992. The expansion has been broadly based,

⁴The Labor government stepped down because it failed to receive a larger percentage of the vote in the 1997 elections than in the 1993 elections.

with strong growth in investments, exports, and private consumption. See figure 30 for Norway's annual GDP growth since 1981.

Figure 30: Real GDP Growth in Norway, 1981 to 1998



Sources: *OECD Economic Outlook 65*, June 1999 and *OECD Economic Outlook 63*, June 1998.

Key Structural Factors of the Norwegian Economy That Affect Fiscal Policy

As a small, trade dependent nation, Norway is sensitive to external factors that affect its economy. Particularly important to Norway's economic performance is its currency exchange rate and inflation rate. Appreciation in the value of its currency makes Norway's exports relatively more expensive, reducing the competitiveness of its export industries. It is also important for Norway that inflation remains at or below the rate of key trading partners. If inflation is higher, then Norwegian goods become more

expensive relative to competitors. The period from the late 1970s to the late 1980s was marked by high inflation and deteriorating cost competitiveness, and on occasion the government devalued the currency to maintain cost competitiveness.

The ability to maintain competitiveness is particularly critical in Norway because a strong petroleum sector could lead to a weaker economy in the long run. Strong petroleum exports put upward pressure on exchange rates, can lead to increased public and private spending, and high inflation. This effect, known as "Dutch Disease," results in a loss of competitiveness to traditional industries exposed to international competition.⁵ Over the long run, as petroleum revenues decline, this could have a negative impact on economic growth when Norway becomes more dependent on other sectors to generate economic growth.

Budget Process

The Norwegian budget process occurs in two distinct steps. First, the government prepares its budget proposal with the Finance Ministry taking the lead. At the beginning of this phase, the Minister of Finance proposes expenditure and revenue ceilings based on economic projections from the Ministry of Finance. Then, the entire cabinet meets to decide spending limits and debate how to allocate the budget. Most of this debate takes place away from public view.

During the second phase of the budget process, the Parliament debates the government's proposal and passes a budget bill. The Finance Committee sets an aggregate ceiling and ceilings for 23 expenditure areas and 2 revenue areas, which must be approved by Parliament.⁶ Parliamentary committees then must develop their budget proposals within the

⁵Dutch Disease refers to the experience of the Netherlands in the 1970s. During this period the Netherlands received large revenues from gas exploration which led to strong economic growth and growth in public expenditures. However, there were unwanted side effects. The exchange rate appreciated resulting in reduced competitiveness. Also, there was a strong rise in real wages, an expansion in services—both public and private—and a contraction in manufacturing. The economy slowed, unemployment increased significantly, and large budget deficits developed in the early 1980s. The government reacted with a large deficit reduction effort. The restructuring of the Dutch economy has taken a long time and the country still suffers from the after-effects of the strong expansion of the 1970s.

⁶This new process was adopted in 1997. Prior to the implementation of expenditure ceilings, spending increases and tax cuts could be passed without any offsets. This was often the case with the budget passed by Parliament usually exceeding the spending proposed by the government.

expenditure limits. It is not unusual for Parliament to change the government's budget proposal.

Measuring Fiscal Position

Norway's main measure of fiscal position is the fiscal budget surplus/deficit, which includes all the activities of the central government and is similar to the United States' unified budget measure. Because of the significance of petroleum revenues in Norway's budget, it also reports a non-oil budget figure, which separates the oil-related revenues and expenditures from the fiscal budget. The difference can be quite large. For example, in 1998 the government recorded a fiscal budget surplus of more than 27 billion krone, while the non-oil budget deficit was about 17 billion krone.

Also, Norway's government uses the non-oil cyclically adjusted balance net of interest payments as a key measure for setting fiscal policy. The government uses fiscal policy in an active manner in an attempt to smooth economic fluctuations and stabilize inflation. Consequently, this measure is important because it shows the impact of the government's core fiscal actions on the economy by removing the effects of oil activities, the economy, and fixed interest expenses. Officials we met with pointed out, however, that it can be difficult to correctly forecast economic performance, and in the past their estimates have varied significantly from actual outcomes.

Norway Adopts Fiscal Policy to Address Long-term Fiscal and Economic Pressures

Over the last 30 years Norway's economy has undergone truly profound changes due to a rapid increase in the size of its petroleum industry. The petroleum industry has grown to account for a large share of both the economy and government revenues. Prior to the arrival of petroleum revenues, Norwegian governments had a history of achieving budget surpluses. While Norway has generally continued to achieve surpluses, they have become increasingly due to petroleum revenues.

Following a prolonged period of slow growth in the late 1980s and early 1990s, Norway developed a new framework to support sustained economic growth. This framework, the so called "Solidarity Alternative," was adopted in 1993 and called for low nominal price inflation, sound public finances, and a stable exchange rate in order to maintain stable economic growth and high levels of employment. This framework was viewed as playing a key role in the fiscal and economic improvement that occurred during the mid-1990s. As a result of fiscal tightening measures and strong growth in

petroleum revenues the budget has improved significantly, with surpluses growing to over 7 percent of GDP in 1997.

As surpluses have developed, the government has adopted a long-term budgetary focus and has called for setting aside budget surpluses to help pay for future expenses. Norway faces the prospect of increasing public pension expenditures at the same time that petroleum revenues are forecast to decline. In order to help pay for these future expenses, the government began depositing budget surpluses in the Government Petroleum Fund in 1996.⁷ Also, the Parliament reformed its budget process, adopting top-down spending and revenue targets in order to help maintain fiscal discipline. However, as called for by the Solidarity Alternative, it became increasingly difficult to maintain fiscal discipline during the current period of strong economic growth. A minority coalition government was elected in 1997 and increased spending above the previous government's proposals. A tight labor market, a sharp drop in oil prices, and turbulence in currency markets have, together, placed increasing strain on the government's ability to maintain fiscal discipline.

**1970s and 1980s: A
Transition to a Petroleum
Based Economy**

The Norwegian economy underwent truly profound changes with the discovery of oil in the late 1960s. Oil production began in 1971 and increased rapidly after 1975. From 1975 to 1985, the petroleum sector grew from about 2.5 percent of GDP to nearly 20 percent, oil and gas exports grew from 9 percent to nearly one half of all exports, and oil tax revenues increased from 2 percent to about 19 percent of total government income.

The impact on the broader economy was no less dramatic. During a period of generally slow worldwide growth, Norway's average annual real GDP growth was 3.8 percent from 1975 to 1983, compared to 1.8 percent for other OECD countries. From 1975 to 1983, unemployment averaged about 2 percent, nearly 5 percent below the OECD average. The government ran budget surpluses from 1975 to 1983 averaging about 3 percent of GDP, compared to an average deficit of 3.5 percent for other European OECD countries. However, budget surpluses were increasingly due to petroleum revenues—the non-oil budget showed a deficit of about 7 percent of GDP in 1983 compared to a surplus of about 4 percent 10 years earlier.

⁷Petroleum fund assets are not specifically earmarked to cover public pension obligations. Therefore, the Fund's assets could be used to cover any government expense.

Almost from the beginning, there was debate about how to manage the petroleum wealth. There were concerns that a strong petroleum sector could crowd out investment in the rest of the economy, leading to a weaker economy in the long run when petroleum revenues declined. Initially, during the early 1970s, it was decided to develop and spend oil revenues cautiously to minimize the impacts on other sectors of the economy. However, attempts to limit the impact of oil on Norway's economy proved unsuccessful as Norway's oil revenues increased more rapidly than planned as a result of a rise in the price of oil and the dollar exchange rate.

Concerns over a dominant petroleum sector crowding out other sectors of the economy proved well founded. Growth in the manufacturing sector stagnated from 1975 to 1985 and employment in that sector dropped by over 13 percent. In response, the government increased subsidies to domestic industries, including shipbuilding, farming, and fisheries. By the mid-1980s, Norway's corporate subsidies were among the highest of OECD nations. The strong petroleum sector and the strong overall economy also had other costs. A tight labor market contributed to persistently high inflation and a decrease in the cost competitiveness of exports, which Norway compensated for by devaluing its currency several times.

1983 Through 1986: An Overheating Economy

Beginning in 1983 and lasting until 1986, Norway experienced a period of strong economic growth. Although, initially the upturn was led by an increase in exports, it was sustained by increasing domestic demand led by expansionary fiscal and monetary policies. Also, the expansion was aided by a steep rise in private consumption caused, in part, by the increased availability of private credit following financial market deregulation.⁸

By 1985, the Norwegian economy had become overheated, led by a surge in private consumption of more than 8 percent, and unemployment fell to about 2 percent. Also, inflation rates remained high and above those of other industrial countries, resulting in a loss of competitiveness, a drop in exports, and a widening trade gap. Largely as a result of the strong economy and strong petroleum revenues, budget surpluses grew to a peak of about 10 percent of GDP in 1985.

⁸Traditionally, Norway had maintained extensive controls over its financial markets, which included controls over the supply of credit available to the private sector. Starting in the late 1970s, Norway began to deregulate its controls over financial markets which had the effect of making credit more available.

**1986 Through 1992: Norway
Experiences the Longest
Economic Downturn in Its
Post-war History**

From 1986 to 1992, Norway experienced the longest economic downturn in its post-war history. A sharp drop in oil prices, from about \$30 a barrel in late 1985 to about \$10 a barrel in 1986, precipitated the downturn. The economic and fiscal effects were severe. Norway experienced a 1-year 10 percent decline in real national income, a 15 percent decline in total export earnings, and a decline in the budget surplus of about 4 percent of GDP. In 1986, the Norwegian currency came under increasing pressure, as investors became concerned over the impact of a fall in oil prices on Norway's economy, and the central bank intervened to defend the currency.

Against this backdrop, a newly elected minority government came to power in 1986 and implemented a strategy to restore economic stability and international competitiveness. The new government devalued the currency by 10 percent, improving the cost competitiveness of its export sector. The government also tightened monetary and fiscal policy to slow down the economy and reduce inflationary pressures. Finally, the new government took several steps to improve Norway's centralized wage negotiation process and to reform its system of industrial subsidies. These measures were intended to improve international competitiveness by reducing wage inflation pressures and improving economic efficiency.

The economic slowdown was also prolonged due to a drop in consumption as consumers attempted to reduce the indebtedness they had built up during the mid-1980s borrowing surge. This retraction was exacerbated by a tax reform package enacted in 1987, which reduced marginal tax rates and the tax deductibility of interest payments, increasing the cost of debt.

The government continued to maintain a tight fiscal policy until 1989 when it changed to a stimulative fiscal policy in reaction to rising unemployment rates. Specifically, the government increased spending on labor market programs, housing loans, and public construction while reducing employer social security contributions in an attempt to stimulate the economy and increase employment. However, just as the economy showed signs of picking up due to increased private consumption in 1990, a general worldwide economic slowdown acted to prolong Norway's slowdown.

**Prolonged Economic
Downturn Leads to
Consensus on the Need for
Fiscal Discipline**

The prolonged economic downturn led Norwegian policymakers to take actions to improve economic performance. As a result, the budget had moved into deficit in 1992 and 1993 for the first time in many years. Unemployment peaked at about 6 percent in 1992—a very high level by

Norwegian standards. Following turmoil in European exchange markets in 1992, Norway was forced to give up its fixed exchange rate policy.

Against this backdrop, the government appointed a commission in 1991 to study the causes of the rapid rise in unemployment. The Commission consisted of representatives from all political parties in Parliament, labor and business groups, economic experts, and government officials. In the summer of 1992, the Commission, with broad support from the major political parties, issued its report recommending a new approach for economic policy—a so called “Solidarity Alternative.”

The Solidarity Alternative established clear roles for fiscal and monetary policy. The government was to use fiscal policy in a counter-cyclical fashion—increasing demand during economic slowdowns and decreasing demand during periods of overly strong economic growth. Monetary policy was to be used primarily to maintain stable exchange rates. In addition, as part of the Solidarity Alternative labor and business leaders agreed to cooperate to mitigate wage inflation pressures. Officials and experts we spoke with felt that the Solidarity Alternative played a key role in the turnaround of the economy.

Norway Sets Goal for Surpluses to Address Long-term Fiscal and Economic Concerns

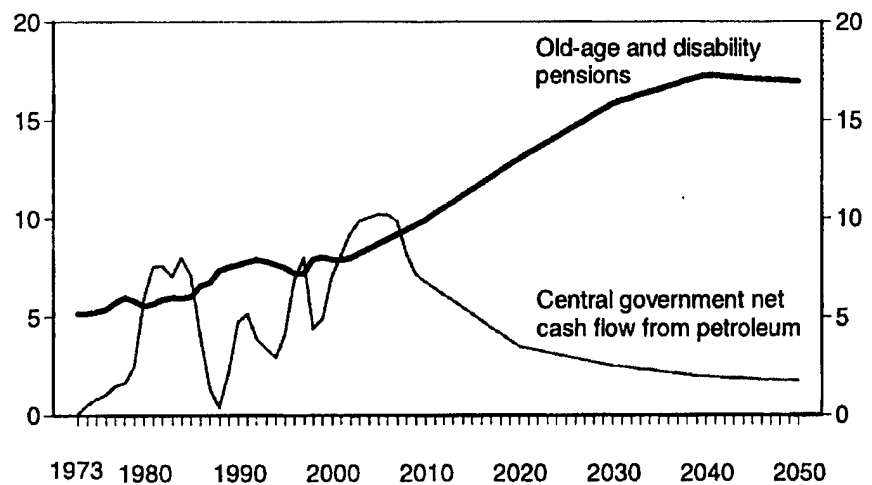
Once the fiscal budget was projected to return to surplus in 1996, the government added a long-term focus to its fiscal policy goals. A major reason for the return to surplus was a surge in petroleum revenues, which more than doubled between 1994 and 1996, and an overall improvement in the economy and in non-oil exports. Also, the government's attempt to limit the growth of “underlying” expenditures (excluding unemployment benefits and one-time items) contributed to fiscal improvement.

With the advent of surpluses, Norway established a goal of sustained surpluses in order to build up savings to address long-term fiscal and economic concerns resulting primarily from an aging population and declining petroleum revenues. (See figure 31.) The goal to save surpluses was based, in large part, on a study of the long-term outlook for government finances.⁹ Specifically, the study projected that petroleum revenues would peak in 2001 at about 8 percent of GDP and decline thereafter to about 1 percent of GDP in 2030. At the same time, public pension expenditures were projected to grow from about 7 percent of GDP to nearly 15 percent. Figure 31 shows the most recent long-term forecast

⁹Long-term Program for 1994-1997, Norwegian Ministry of Finance.

extended out to 2050. This long-term problem has been presented as the primary rationale for the current fiscal policy of sustained surpluses.

Figure 31: Long-term Projections for Pension Expenditures and Petroleum Revenues as a Percentage of GDP in Norway, 1973 to 2050



Source: Statistics Norway and Norwegian Ministry of Finance.

The government's projections showed that it was necessary to accumulate financial reserves to help pay for increasing public expenditures. As a vehicle for accumulating assets, the government created the Government Petroleum Fund in 1991 to help manage Norway's petroleum wealth over the long term. The Government Petroleum Fund serves several important fiscal and economic functions. By investing surpluses, the Fund is an instrument for saving part of Norway's petroleum revenues for the next generation. Also, the Fund's assets are invested in foreign stocks and bonds to help reduce inflation and upward pressure on the exchange rate. Low inflation and a stable exchange rate help to keep Norway's exports competitive with other countries. If Norway allowed excess petroleum revenues to remain in the domestic economy it could result in higher levels of inflation and a real appreciation of its currency. As a result, non-oil industries would become less competitive over time as the price of their goods and services would rise relative to foreign competitors. This is a major concern to policymakers because petroleum output is projected to decline early in the 21st century, and Norway will have to rely more on its

non-oil industries to generate economic growth. If those industries lose their competitiveness now, it could have a negative impact on long-term economic growth when the petroleum industry declines. Consequently, policymakers in Norway have come to view surpluses as critical to the long-term fiscal and economic health of the country, and the Fund has become a symbol of the importance of saving for future needs.

Budget Process Reformed to Sustain Fiscal Discipline

The Norwegian Parliament reformed its budget process in 1997 to show its continued support for fiscal discipline and in reaction to past spending increases. For the first time, the Parliament adopted a top-down approach to budgeting, setting aggregate revenue and expenditure ceilings. Under the old procedure there was no agreement on an overall expenditure and revenue limit at the beginning of the budget process, and the final budget represented the aggregate of individual spending decisions. As a result, the previous budget process often led to Parliament increasing spending above the government's proposed levels. Under the new budget process, Parliament agrees on an overall fixed budget ceiling and ceilings for 23 spending and 2 income areas at the beginning of the budget process. All spending and revenue proposals must fit within these ceilings.

Surplus Policy Comes Under Pressure

During the 1997 elections, the then governing Labor party promoted continued austerity in order to avoid making the mistakes that occurred during the 1980s, while several smaller opposition parties called for increased spending on various social programs. In order to ensure support for continued fiscal discipline, the Labor party vowed to step down unless it received an equal percentage of the popular vote in the election as in the previous election. The Labor party failed to garner an equal percentage of votes and stepped down as promised, despite holding the largest number of seats in Parliament. A minority coalition took over, and its first budget proposed to increase spending on pensions and family allowances.

In 1998, a sharp decline in oil revenues led to a sharp decline in the budget surplus, including oil revenues, from about 7 percent of GDP to about 4 percent of GDP. Financial markets became concerned over the relatively easy stance of fiscal policy, resulting in strong downward pressure on Norway's currency. In late 1998, the Central Bank was forced to step in and defend the currency. Furthermore, a tight labor market has led to increased inflationary pressures. Consequently, it may be difficult for a weak minority coalition government to maintain fiscal discipline in light of the pressures that have emerged since 1997. Nonetheless, the government remains

committed to the Solidarity Alternative and maintaining surpluses to be invested for the future.

Conclusion

Norway has had a long history of budget surpluses and fiscal discipline. With the discovery of oil in the late 1960s, the Norwegian economy and fiscal position have come to be increasingly influenced by oil activities. Following a prolonged period of slow economic growth in the late 1980s and early 1990s, the government reached a broad consensus on the need to take actions to sustain economic growth and maintain full employment over the long term. Part of this agreement called for fiscal policy to be used in a counter-cyclical fashion and has been a major reason why Norway has been able to maintain fiscal discipline throughout the latter half of the 1990s. With the arrival surpluses in 1996, the government has added a long-term focus to its fiscal goals and now calls for surpluses to be saved to help pay for future budgetary pressures. However, this framework has come under increasing pressure due to a weak minority government, a strong domestic economy, and turbulence in international currency markets. Nevertheless, the current government remains committed to the Solidarity Alternative and maintaining surpluses to be invested for the future.

Sweden

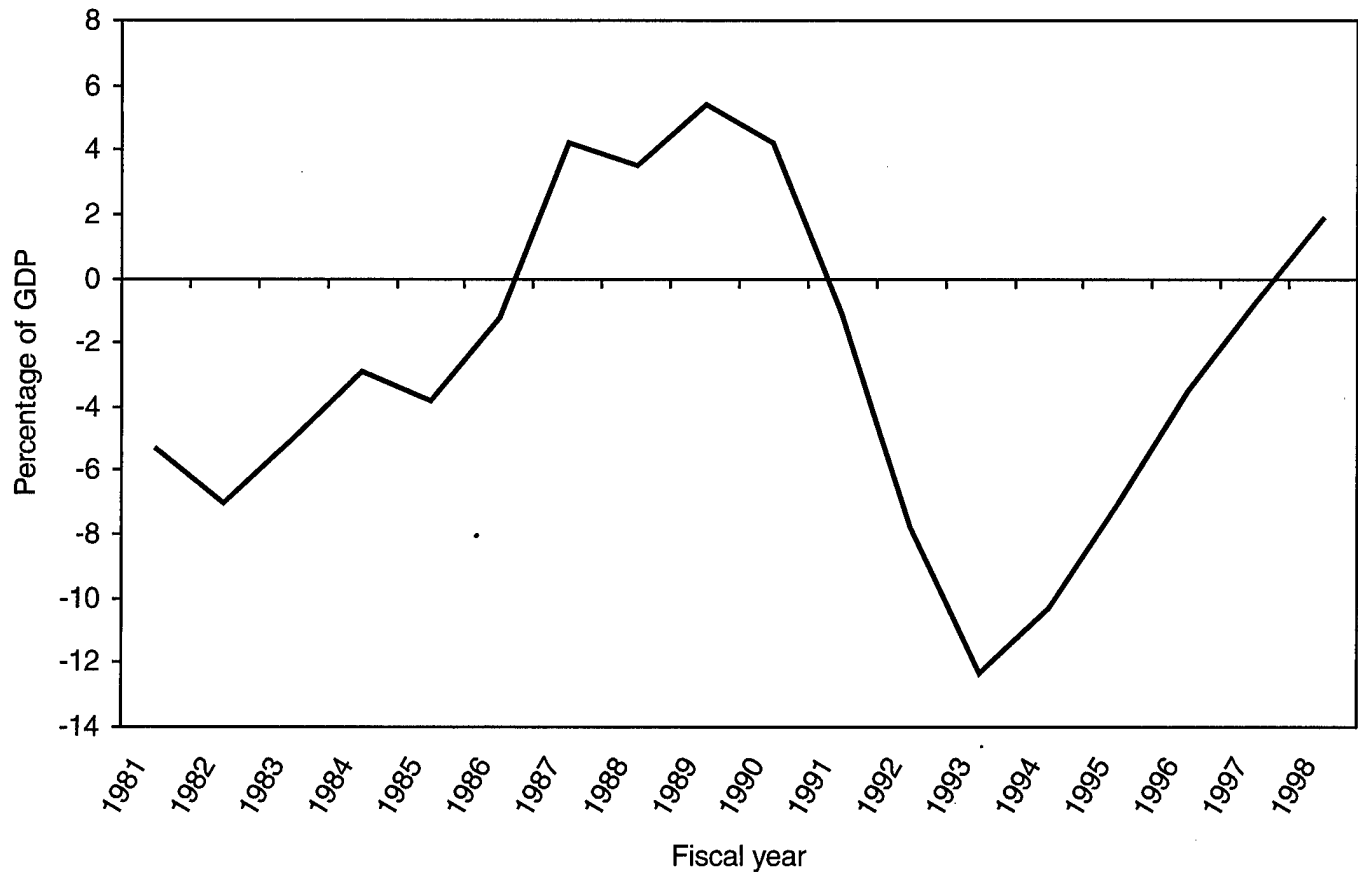
Since the early 1980s, Sweden has experienced 2 periods of budget surpluses: 1987 through 1990 and again beginning in 1998.¹ Surpluses achieved in the late 1980s were largely the result of the deficit reduction program begun in 1982 and a strong economy. During this period, the government did not have an explicit policy to sustain surpluses and generally attempted to use fiscal policy to stabilize the economy and control inflation. Deficits reemerged in 1991 as the economy slipped into its worst recession since the 1930s. The budget swung from a surplus of about 4 percent of GDP on a general government basis in 1990 to a deficit of more than 12 percent of GDP 3 years later. Unemployment increased sharply, several large banks nearly failed, and the currency was devalued.

In response to the economic crisis of the early 1990s the government undertook a series of major reforms. In 1992, Sweden ended its policy of maintaining a fixed exchange rate by changing the focus of monetary policy to controlling inflation. As a result, the use of fiscal policy to stabilize the economy and control inflation was reduced. The government focused its fiscal policies on deficit reduction and, in 1994, introduced a package that attempted to reduce the deficit by about 7 percent of GDP over 4 years. To support the deficit reduction program, the government reformed its budget process to include, for the first time, the use of spending caps. Finally, Sweden overhauled its pension system with the goal of making it permanently sustainable. By 1998, Sweden returned to a budget surplus and had set as its fiscal objective running surpluses averaging 2 percent of GDP. Figure 32 shows Sweden's general government financial balance as a percentage of GDP from 1981 to 1998.²

¹In 1995, Sweden changed its measure of fiscal position to a general government measure, which includes not only the central government's fiscal position, but also the fiscal position of local governments and its public pension funds. Prior to 1995, budget figures refer primarily to the central government budget. The fiscal surplus was positive for both the central and general government in 1987-1990. Sweden has also changed its fiscal year from July 1 to January 1; 1997 was the first budget year to coincide with the calendar year.

²General government financial balance includes the financial balance of the federal government, the public pension system, and local government.

Figure 32: General Government Financial Balance in Sweden, 1981 to 1998



Sources: *OECD Economic Outlook* 63, June 1998 and *OECD Economic Outlook* 65, June 1999.

Background

Sweden is a constitutional monarchy with a parliamentary form of government. The Swedish Parliament, the Riksdag, is unicameral with 349 members. Sweden has a proportional electoral system, with 310 members elected from districts, while the remainder are nominated by their parties in order to achieve a nationally proportional result.³

³A party must gain at least 4 percent of the national vote to qualify for representation.

General elections for Parliament are held in Sweden every 4 years.⁴ A government forms from the political party, or coalition of parties, that can garner the majority support of Parliament. However, the governing party or parties do not need a majority of seats in Parliament. Governments have no specific term limit and can remain in office for as long as they maintain majority support of Parliament. A change in government can occur after an election when a governing party or coalition loses its majority or when a sitting government resigns. If at least half the members of Parliament support a vote of no confidence, the government is forced to resign. No government has actually been overthrown by a formal vote of no confidence. Occasionally, however, governments have resigned after losing important votes in Parliament, in effect an informal vote of no confidence. Governments have also resigned as a result of internal disagreements; this occurs most often with coalition governments.

For most of the last 60 years, Sweden has had minority or coalition governments. The Social Democratic Party, a left-of-center party generally representing the interests of labor, has held power for approximately 58 of the last 67 years. After losing the 1991 election, the Social Democrats returned to power in 1994 with 46 percent of the vote. After the election in 1994, the Social Democratic minority government was first supported by the Left Party, then by the Center Party. In the September 1998 elections, the Social Democrats' share of the vote dipped to 36.4 percent. However, they were able to remain in power with the support of the more politically left-of-center Green and Left parties. Göran Persson is the current Prime Minister.⁵

The cabinet, headed by the Prime Minister, is the decision-making body for the government. It is composed of the Prime Minister, a Deputy Prime Minister, 13 Heads of Ministry, and 7 Ministers without portfolio. Cabinet Ministers are appointed by the Prime Minister and are generally representatives of the political party or parties in power. They are often, but not always, members of the Parliament. The government is responsible for preparing the budget, which is submitted to Parliament in September.

⁴Governments may call for an election between regularly scheduled elections, with the results of a mid-term election remaining in effect only until the next scheduled election.

⁵Göran Persson was appointed Prime Minister in March 1996 after Prime Minister Ingvar Carlsson resigned as leader of the Social Democrats.

The Swedish Economy

Sweden has a small economy that is dependent on trade—its GDP is less than 3 percent the size of the U.S. economy and exports accounted for over 35 percent of GDP in 1997, compared to about 9 percent for the United States.

Recent Economic History

During the 1970s, Sweden's economy experienced an extended period of slow growth similar to that of other developed economies. Between 1974 and 1984, average annual growth was 1.3 percent, about 2 percentage points lower than the previous 10 years. During this period of slow growth, Sweden continued to pursue a policy of full employment, financed largely by increased public sector borrowing. As a result, Sweden's public expenditures grew at a fast rate during the 1970s, reaching a peak of nearly two-thirds of GDP in 1982. Under this fiscal policy, Sweden maintained a low unemployment rate—but at the cost of high inflation and large budget deficits.

By the early 1980s, Sweden was experiencing slow economic growth, high inflation, and growing budget deficits. Beginning in 1982, Sweden enacted an economic and fiscal reform package designed to help revive the economy and reduce budget deficits. During the early and mid-1980s, Sweden's government also deregulated its financial markets, which included the removal of governmentally-imposed limits on the amount of credit that banks could issue in a given year.⁶ The increased availability of credit led to a surge in borrowing and a large increase in consumer spending and real estate investment.⁷ These reforms contributed to a sustained period of growth beginning in 1982 and ending in 1990.

In 1990, the Swedish economy entered its worst recession since the 1930s, due largely to a slowdown in consumer spending and a slowing world economy. Consumer spending slowed as borrowing costs increased due in part to a government tax reform package which decreased marginal tax rates on capital income and reduced the deductibility of interest costs. A loss in confidence by investors in the underlying strength of the economy led to strong downward pressure on the value of Sweden's currency. The

⁶Sweden's government set borrowing and lending ceilings in an attempt to control credit growth.

⁷Interest payments were deductible from income taxes, which, combined with high marginal tax rates and a relatively high inflation rate, led to a negative real rate of interest for many borrowers.

government's attempts to maintain the fixed exchange rate exacerbated the economic slowdown; interest rates for loans in the central bank were increased to 500 percent in the fall of 1992 in an attempt to defend the currency. Economic growth was negative from 1991 to 1993, and registered unemployment increased dramatically from about 2 percent in 1990 to over 8 percent in 1993. The slowing economy also precipitated a banking crisis requiring the government to bail out several banks. The economic slowdown and banking bailout had dramatic fiscal effects leading to a sharp increase in budget deficits, which peaked at over 12 percent of GDP in 1993.

In reaction to the economic and fiscal crisis, the government took a number of steps to revive the economy and bring the fiscal situation under control. First, Sweden ended its fixed exchange rate policy in 1992 and reoriented monetary policy toward a focus on controlling inflation. In late 1994, a newly elected Social Democratic government put in place a deficit reduction package totaling over 7 percent of GDP over 4 years. Sweden also reformed its budget process to include expenditure caps and reformed its pension system. By 1994, the economy had begun to turn around. (See figure 33.) In the later half of the 1990s, inflation has remained low and stable, unemployment rates have begun to come down, and the budget moved into surplus in 1998.

Figure 33: Real GDP Growth in Sweden, 1982 to 1998



Source: OECD Economic Outlook 65, June 1999.

Key Structural Factors of the Swedish Economy That Affect Fiscal Policy

As a country with a small, open economy, Sweden is sensitive to external factors that affect its economy. Particularly important to Sweden's economic performance is its exchange rate, as appreciation in its currency makes Sweden's exports more expensive and reduces its competitiveness. Prior to 1992, Sweden generally pursued a fixed exchange rate policy. Since 1992, it has allowed its currency to float on the open market.

Prior to 1992, Sweden's primary tool to regulate exchange rates was monetary policy. However, as a result, monetary policy was limited in its ability to control inflation. Containing inflation at the rate that prevails abroad is important to maintaining a fixed exchange rate. Through the

early 1990s, Sweden attempted to control inflation primarily through the use of fiscal policy. However, fiscal policy was often expansionary, even during economic booms, generally adding pressure to an overheating economy and higher rates of inflation. Consequently, Sweden's fixed exchange rate policy was ultimately unsuccessful, and the central bank was unable to defend the value of the currency.

Budget Process

Sweden began its budget process reforms in 1994 based, in large part, on several studies showing its process was weak in its ability to control overall spending. The reforms put in place a top-down budget process intended to facilitate spending constraint and lead to better budget outcomes. The new budget process was fully implemented in 1997. These reforms are now viewed as a major factor contributing to Sweden's recent fiscal improvement.

Sweden's budget reforms focused on achieving better fiscal outcomes, mainly by placing controls on spending. For example, the new process requires the adoption of fiscal policy targets for a 3-year period, including expenditure ceilings. Operating under a 3-year time horizon, each year the government adds the overall expenditure ceiling for the third year, keeping in place previously agreed to expenditure ceilings. Expenditure ceilings may be changed in exceptional cases, but since they were introduced, there have been no increases of previously agreed to ceilings.⁸

The adoption of a top-down approach to budgeting represents a significant change for Sweden. Prior to the reforms, top-down targets were generally not used by the government or by Parliament. In fact, the general trend was that Parliament would increase spending above the government's budget proposal. Under the new process Parliament passes a bill establishing the aggregate spending level 3 months prior to the government's final budget proposal. The government's budget proposal must conform with these limits established by Parliament. Parliament, upon receiving the government's budget proposal, then prepares its own budget bill allocating expenditures among 27 expenditure areas. By passing expenditure ceilings at the beginning of the parliamentary budget process, the new process

⁸However, the ceilings have been adjusted for technical reasons. For example, with the introduction of the new pension system, ceilings were adjusted since pension fees were to be paid on transfers. The fiscal balance for the general government was not affected by this change. The ceilings have not been changed due to inability to contain spending.

limits the ability of Parliament to increase spending once overall targets are agreed upon.

Measuring Fiscal Position

Sweden's main measure of fiscal position is the general government financial balance, which includes the central government budget, the local government sector, and Sweden's public pension system. Prior to 1995, the government focused primarily on the central government budget, also known as the state budget. After joining the European Union (EU) in 1995, Sweden's primary measure of fiscal position became the general government financial balance. EU member countries must comply with the Growth and Stability Pact. Under the Pact, countries agree to support the economic growth and stability of the Union, by, among other things, keeping government budgets close to balance and maintaining low levels of debt. The EU assesses compliance with the balanced budget requirement using a general government financial balance measure because it includes all levels of government activity allowing for better comparisons across countries. Consequently, Sweden chose this measure as its primary measure of fiscal position.

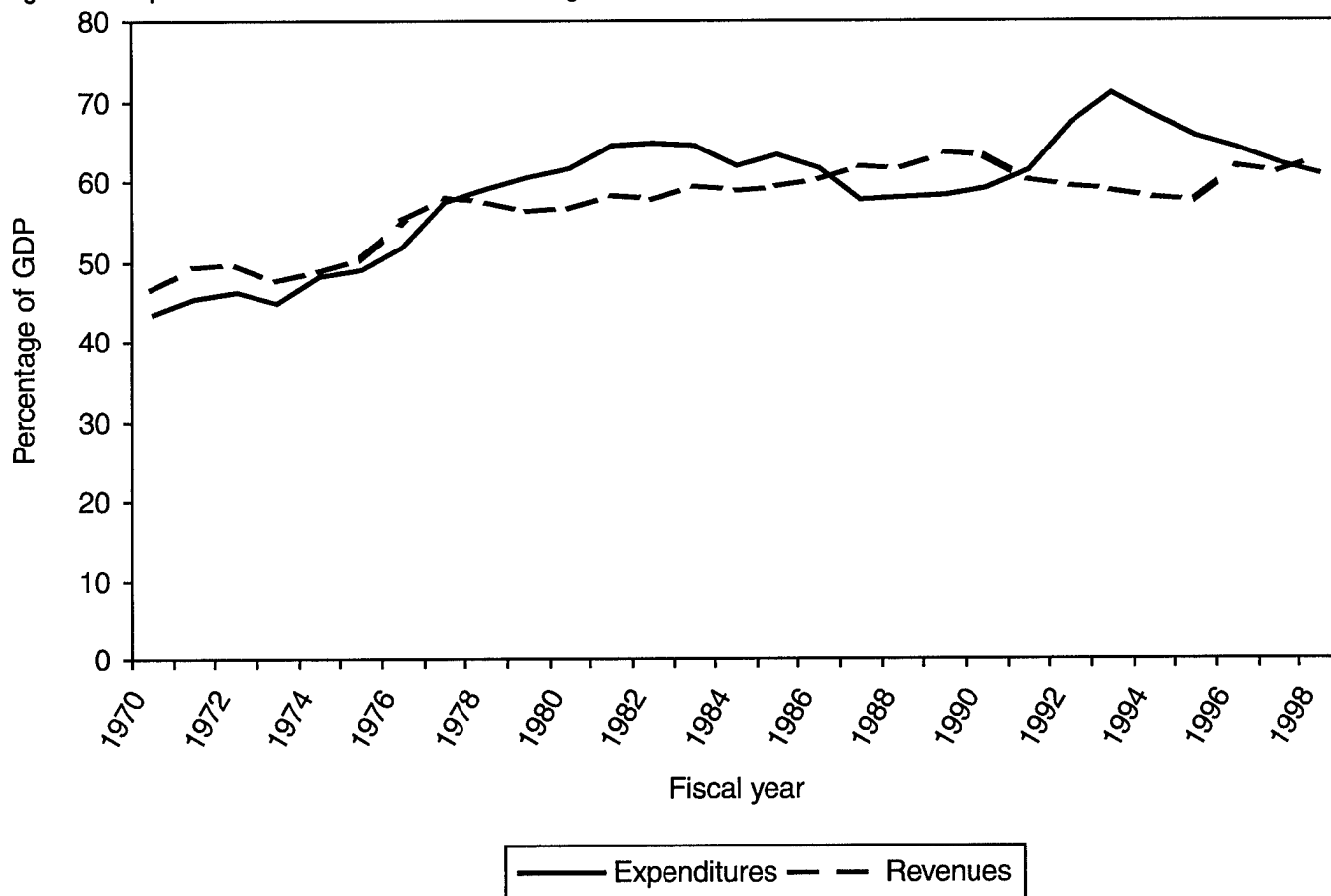
However, when planning the budget the government also focuses on the expenditure ceiling. The overall expenditure ceiling includes central government spending as well as the public pension system. Until the recent focus on the general government financial balance, Sweden's pension system was considered separately from the rest of the central government budget. The pension system funds are still accounted for separately from central government revenues, and surpluses accumulating in the pension system are invested in marketable securities, i.e., they are not used to reduce the government's public borrowing needs.

Sweden's Fiscal Policy in the 1970s, 1980s, and 1990s

Sweden's public expenditures, taxes, and deficits all increased at a significant rate throughout the 1970s as the government reacted to an economic slowdown by attempting to use fiscal policy to stimulate the economy and reduce unemployment. By 1982, public expenditures totaled about two-thirds of the economy, up dramatically from less than 45 percent in 1970. Revenues also grew at a rapid rate during this period—increasing from about 48 percent of GDP in 1970 to about 58 percent of GDP in 1982. (See figure 34 for expenditures and revenues as a percent of GDP from 1970 to 1998.) As rapidly as revenues grew, they did not grow fast enough to offset rapidly increasing expenditures, and very large deficits emerged by

the early 1980s. In 1982, the central government's deficit stood at nearly 10 percent of GDP.

Figure 34: Expenditures and Revenues as a Percentage of GDP in Sweden, 1970 to 1998



Sources: *OECD Economic Outlook 42*, December 1987 and *OECD Economic Outlook 65*, June 1999.

Beginning in 1982, a newly elected government enacted an economic and fiscal reform package aimed at improving economic performance and reducing the budget deficit. The government's efforts were largely successful leading to an economic recovery, which lasted until 1990. As a result, the budget reached surplus from 1987 until 1990. During this surplus period, the government's fiscal policy was generally neutral as attempts to

tighten fiscal policy to slowdown an overheating economy failed to garner support in Parliament. Beginning in 1990, the Swedish economy entered its worst economic slowdown since the 1930s, with economic growth falling by about 5 percentage points from 1991 to 1993 and the unemployment rate reaching record levels. The economic slowdown was a major factor contributing to a substantial deterioration in public finances during this period. From 1990 to 1993, Sweden's budget went from a surplus of about 4 percent of GDP to a deficit of more than 12 percent. The large deficits resulted in an explosion of government debt, with general government gross debt nearly doubling as a percentage of GDP from 1990 to 1994.

In reaction to the crisis, Sweden's main fiscal objective changed during the mid-1990s from a focus on maintaining full employment to a focus on reducing budget deficits and stabilizing debt as a share of GDP. Sweden put in place an austere deficit reduction program in fiscal year 1994-95 with spending reductions and revenue increases totaling about 7 percent of GDP through 1998. Sweden also overhauled its budget process with the aim of constraining spending. These efforts played a critical role in Sweden's ability to eliminate budget deficits. In 1998, Sweden ran a small surplus and now projects surpluses for the next 3 years. Sweden's current stated fiscal goal is to run surpluses of 2 percent of GDP, on average, over the economic cycle.

The government has also made reforms aimed at improving its long-term fiscal health. During the mid-1990s, Sweden overhauled its public pension system when it became apparent that the system was unsustainable and would run out of money early next century. Sweden's pension system is run separately from central government finances—tax revenues go directly to the pension system and excess monies are invested in stocks and bonds through one of several government-managed funds. Consequently, the pension reform debate occurred separately from the general budget debate, and prior to any debate about the need for surpluses.

1982 Through 1987: A Period of Deficit Reduction

Sweden began the early 1980s in the midst of fiscal and economic crisis. Sweden's public sector had grown throughout the 1970s to account for about two-thirds of the economy in 1982, the largest proportion among developed economies at that time. However, the increase in expenditures throughout the late 1970s was not matched by an increase in revenues, and large budget deficits developed, peaking at about 7 percent of GDP in 1982. Government debt also grew rapidly during the late 1970s and early 1980s, reaching its peak of about 67 percent of GDP in 1984. By the early 1980s,

Sweden was experiencing slow growth, high inflation, and rising unemployment.

Against this backdrop, a newly elected Social Democratic government came to power in 1982 and enacted a comprehensive economic stabilization program in an attempt to address concerns over economic underperformance and persistent budget deficits. The first step in the stabilization program was a devaluation of the currency to make Swedish exports more cost competitive and boost economic growth by increasing exports. Secondly, the government attempted to reduce the budget deficit by reducing expenditures gradually as the economy recovered. The economy did pick up beginning in 1982, but the deficit initially worsened as the devaluation increased the interest costs of the government because a large portion of its debt was denominated in foreign currencies.⁹ Also, the government initially increased spending in an attempt to limit the negative economic effects of the devaluation and to fulfill campaign promises. Finally in 1983, the government proposed a deficit reduction program containing both spending cuts and tax increases.

Over the next 3 years, the government continued to focus fiscal policy on reducing the size of public expenditure and debt. From 1982 to 1986, the general government financial deficit was reduced from 7 percent of GDP to about 1 percent of GDP, primarily due to spending restraint and aided by an improving economy. For example, interest payments were reduced in 1985 due to a depreciation in the U.S. dollar—nearly one half of Swedish public debt at that time was denominated in U.S. dollars.

⁹Interest payments on foreign denominated debt must be made in that currency. Consequently, a devaluation in the Swedish krona made these payments more expensive.

The government's economic stabilization package led to a rapidly improving economy, which also contributed to improving budget figures. For example, the 1982 currency devaluation increased the price competitiveness of Swedish exports and led to a temporary increase in exports. Also, the government's deregulation of the credit markets made credit more readily available to consumers and businesses. As a result, consumers increased their borrowing leading to increased growth as borrowed money was used for consumption and investment spending, especially in real estate.¹⁰ The growing economy, coupled with the cuts in spending, greatly improved Sweden's fiscal position, and it achieved a budget surplus in 1987 and in the next 3 years.

1987 Through 1990: A Period of Surpluses

Sweden achieved budget surpluses for 4 years beginning in 1987 largely as a result of the booming economy and deficit reduction efforts. During this period, Sweden did not have an explicit policy for sustaining surpluses, as fiscal policy was focused on maintaining full employment and controlling inflation. Under such a regime, fiscal policy would be tightened—i.e., taxes raised or spending cut—during periods of inflationary growth.

However, during the surplus period, the government's fiscal policy varied from year to year as a lack of political consensus halted most attempts to tighten fiscal policy. With the arrival of surpluses in 1987, the government continued with its attempts to tighten fiscal policy, and in 1988 the government's fiscal policy was broadly neutral. In an attempt to tighten fiscal policy in its fiscal year 1989-90 budget, the government proposed an increase of 2 percent in the value-added tax (VAT). However, the minority government was unable to develop enough support for its passage. Instead, Parliament passed a temporary compulsory savings scheme as part of a more limited attempt to tighten fiscal policy. By 1990, the economy was beginning to weaken, and in 1991 the budget went back into deficit where it remained for 7 years.

1991 Through 1998: A New Focus for Fiscal Policy

In the early 1990s, Sweden experienced its worst recession since the 1930s. In 1991, the government enacted a tax reform package that lowered marginal rates and eliminated certain deductions, including the consumer

¹⁰Interest on consumer loans was tax deductible in Sweden at the time. With high marginal tax rates and a high rate of inflation, many borrowers were able to borrow at a negative real interest rate.

interest deduction. As a result, consumer spending slowed dramatically as the cost of borrowing became more expensive despite the income tax cuts. Also, a loss of confidence in the Swedish currency led to downward pressure on its value, which the government initially tried to defend. The central bank raised overnight interest rates to over 500 percent, a record high for any country at that time. However, the high interest rates further slowed the economy, and consumer confidence declined as the efforts to defend the currency were unsuccessful. GDP growth turned negative from 1991 through 1993 and unemployment jumped from 2 percent in 1990 to 7.5 percent in 1993. These economic events had a significant impact on the fiscal policy of the 1990s and reinforced the need to maintain fiscal discipline.

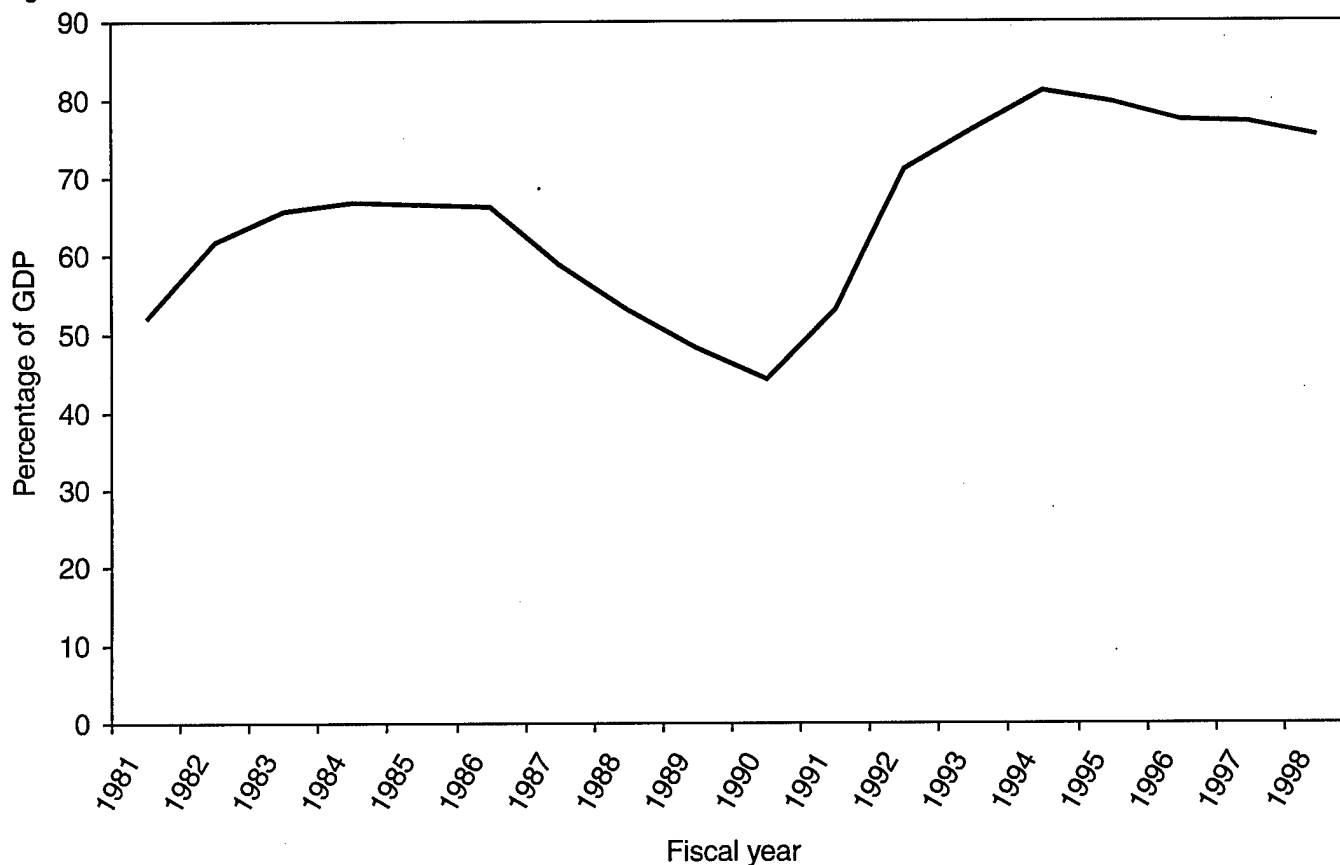
During the initial stages of the economic crisis, the government focused its fiscal policy on reviving the economy by increasing spending and addressing specific crises such as the near failure of several large banks. Because monetary policy was focused on defending the currency, interest rates were raised significantly, acting to slow the economy and working against the government's attempts to stimulate the economy through fiscal policy. The economic slowdown and large jump in unemployment had a severe impact on the budget, mostly due to the large size of the government as a share of the economy. Sweden has a generous social welfare system and spending increases rapidly when the economy slows. During the early 1990s, outlays increased rapidly, from about 59 percent of GDP in 1990 to over 70 percent in 1993. Also, tax receipts fell from over 63 percent of GDP in 1990 to about 59 percent in 1993 due primarily to lower than expected receipts from the 1991 tax reform and a change in the composition of GDP toward areas with lower tax rates.¹¹ As a result of increasing expenditures and falling revenues, Sweden's budget deficit peaked at over 12 percent of GDP in 1993. Debt also increased during this period with gross debt nearly doubling from 1990 to 1994, where it peaked at over 80 percent of GDP. (See figure 35 for Sweden's debt level from 1981 to 1998.)

By 1993, the focus of fiscal policy had changed from stimulating the economy and maintaining full employment to bringing the budget back under control by lowering deficits and stabilizing debt. In April of 1993, the government announced a deficit reduction package which amounted to about 5 percent of GDP and included reductions in subsidies for medical

¹¹Tax receipts also dropped for technical reasons. For example, employers' social security contributions for sickness benefits were reduced.

and dental care, indexation of certain taxes, and increased contribution rates for the unemployment benefit system.

Figure 35: General Government Gross Financial Liabilities in Sweden, 1981 to 1998



Note: Number for 1998 is an estimate.

Sources: *OECD Economic Outlook* 63, June 1998 and *OECD Economic Outlook* 65, June 1999.

With a stagnant economy and a deteriorating fiscal position, a real sense of crisis permeated the 1994 elections. Nearly all political parties put forth plans to bring deficits under control and revive the economy. This was a major change in focus from past elections where parties generally focused on proposing new initiatives that would lead to spending increases. The Social Democrats were returned to power after 3 years out of office and

immediately began to implement a deficit reduction program. Their stated fiscal policy was to balance the budget by 1998 and to stabilize debt as a percentage of GDP. To accomplish this goal, the government presented a series of deficit reduction packages, with expenditure reductions accounting for about 60 percent of the improvement and revenue increases accounting for the other 40 percent. These measures were projected to total about 7.5 percent of GDP by 1998.

**New Budget Process
Designed to Control
Spending**

To support its deficit reduction effort, the new government overhauled the budget process. Under the new process, the government established a top-down approach whereby it set aggregate spending levels before any programmatic initiatives were proposed. Under the new process, Parliament enacted an aggregate expenditure ceiling and ceilings for 27 spending categories for the current budget year and the next 2 years. The expenditure ceilings were set on a rolling basis, with a new ceiling set for the third year only. Sweden's expenditure ceilings are noteworthy because they cover entitlement programs, such as social security.¹²

Several experts we spoke with felt the new budget process was a critical factor in Sweden's fiscal improvement. The multi-year expenditure limits have been particularly important because they make it difficult to increase spending if the budget improves more than forecast. This is especially important as Sweden enters a new period of budget surpluses.

**Government Sets Goal for
Surpluses to Reduce Debt
and Maintain Investor
Confidence**

The government has surpassed its fiscal goals due in large part to a stronger than expected economy. In 1996, when it became apparent that Sweden would achieve balance sooner than expected, the government established a new fiscal policy goal to run surpluses after 1998. In 1997, the government defined its long-term goal as running surpluses of 2 percent of GDP, on average, over the business cycle—surpluses would gradually increase after 1999, reaching 2 percent of GDP in 2001. The government's primary reason for wanting to run surpluses was to reduce the debt level which shot up dramatically in the early 1990s. Also, the government wishes

¹²If the expenditure ceiling for an entitlement program is exceeded in any year, it will not necessarily result in benefits being cut off. Rather, the spending ceiling for entitlement programs, in effect, acts as an early warning system. The government closely monitors spending in these areas throughout the year, and when cost overruns become apparent, a decision must be made to find extra funds from other categories, cut benefits, or raise the ceiling.

to maintain investor confidence in its fiscal and economic policies. By running surpluses, the government hopes to increase its future fiscal flexibility should another crisis materialize. The economic and fiscal crisis of the early 1990s has continued to significantly affect policymakers, resulting in a general consensus on the need for continued surpluses. Nonetheless, there has been some disagreement over how big surpluses should be and how extra surpluses should be used. Several political parties have called for smaller surpluses and have proposed using them for tax cuts or spending increases.

The budget process reforms enacted to support deficit reduction efforts have continued to play an important role in shaping fiscal policy decisions as Sweden has entered a period of surplus. The government established expenditure ceilings for 1998 that would enable it to achieve the goal of a surplus of 2 percent of GDP by 2001. However, due to continued strong economic growth, and other technical factors, they have achieved their surpluses sooner.¹³ As larger than expected surpluses have developed, the government has reiterated its commitment to the previously enacted expenditure ceilings. At the same time it has been able to increase spending somewhat because of the way the expenditure ceilings work. Under Sweden's new budget process, all open-ended appropriations—mostly to entitlement programs—were abolished, making all expenditures subject to annual reviews. To provide a buffer against forecasting errors in these programs, the government built a “budget margin” into the expenditure limits. Thus, to the extent economic and budget forecasts turn out to be accurate or better than expected, the government can increase spending up to the amounts allowed under the expenditure ceilings.¹⁴ Since the expenditure ceilings have been in place, the economy has outperformed the forecasts, freeing up additional room for spending.

More recently, the government has proposed spending cuts to remain beneath the expenditure ceiling. In April 1999, the government proposed spending cuts for savings of about 7.7 billion kronor in 1999 and nearly 9 billion kronor in 2000.

¹³For example, in 1998, the government incorporated the National Pension Fund's real estate holdings, which resulted in an upward adjustment of the financial balance due to government accounting rules.

¹⁴If budget or economic forecasts turn out to be overly optimistic, then the government would presumably be forced to take action to stay within expenditure limits by cutting spending. There is some additional flexibility to borrow against future year expenditures.

By remaining committed to the expenditure ceilings, the current debate over surpluses has been limited to debt reduction and/or tax cuts. The fiscal year 2000 budget projects that surpluses will exceed 2 percent of GDP in the year 2000, 1 year prior to the original plan. As a result, the government has proposed tax cuts as part of its fiscal year 2000 budget. Specifically, the government has proposed income tax cuts worth about 10 billion kronor in fiscal year 2000 as well as reductions in some property taxes.

Sweden Has Acted to Address Long-term Fiscal Pressures

Like many other western economies, Sweden faces fiscal pressures associated with an aging population. However, Sweden has taken steps to address some of these pressures by redesigning the state pension system from a pay-as-you-go defined benefit system, to a partially funded, defined contribution system.¹⁵ Further, the new system is designed to allow for changes in longevity and economic performance by adjusting benefits accordingly—making it essentially a self-sustaining system. Sweden also provides comprehensive health coverage for its citizens, but the impact of an aging population is unclear.

Sweden's pension reform occurred in large part due to perceptions that the system was unsustainable in the long run and was forecast to run out of money early next century. Debates about Sweden's pension system have traditionally been separate from budget debates because the system has been "off-budget." This has been the case even though the pension system has run annual surpluses since its inception. These funds have been invested in several bond and stock funds and as a result have not been available to offset other government spending.

Conclusion

Over the past two decades, Sweden has experienced two periods of budget surpluses, coinciding with its two periods of strong economic growth. During its first period of surplus, Sweden had no clear policy related to sustaining the surplus. Attempts were made to tighten fiscal policy during this period, but political consensus was difficult to reach.

¹⁵Sweden also provides a basic pension, available to all eligible citizens regardless of earnings, financed out of general revenues.

Appendix V
Sweden

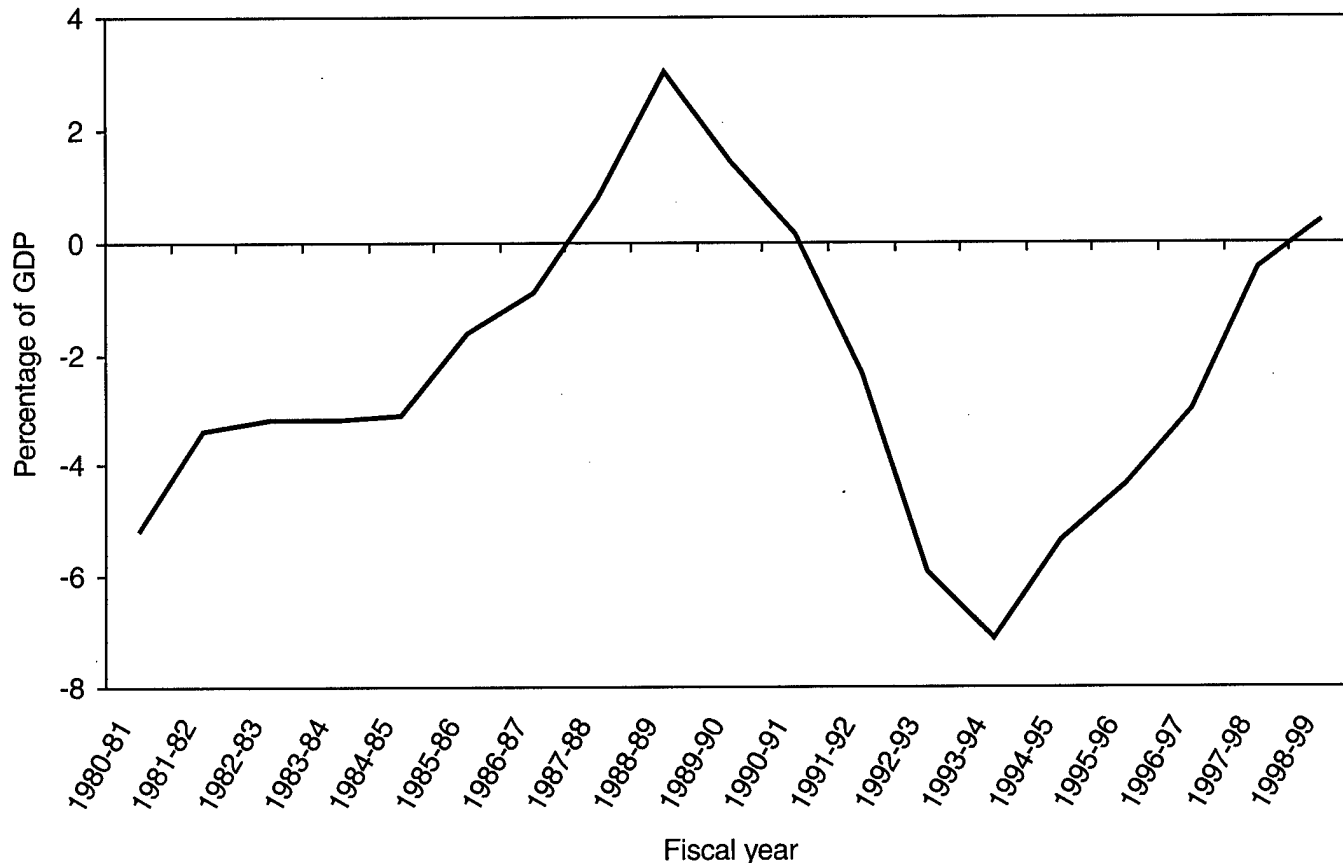
Sweden experienced a severe economic downturn in the early 1990s and as a result has implemented a number of economic, fiscal, and institutional reforms. Sweden enacted a large deficit reduction program, changed the role of the central bank and monetary policy, redesigned its budget process, and reformed its pension system. As a result of these changes, and an improving economy, the budget has moved back into surplus, debt has been reduced, and the government has established a goal for surpluses equal to 2 percent of GDP.

United Kingdom

The United Kingdom experienced a 4-year period of budget surpluses from fiscal years 1987-88 through 1990-91.¹ The government's fiscal strategy never called for running surpluses, and the arrival of surpluses was unexpected. Once surpluses materialized, the government planned to gradually bring the budget back into balance. In accordance with this policy of phasing out surpluses and given the economic forecasts at the time, the government cut taxes substantially and increased spending. These forecasts proved to be overly optimistic and, in the early 1990s, the economy slipped into recession. This combination of tax cuts, additional spending, and slower growth led to a deterioration in the United Kingdom's fiscal position. Deficits reemerged in fiscal year 1991-92 and grew rapidly over the next 2 years, hitting a peak of over 7 percent of GDP in fiscal year 1993-94. Consistent with the goal of a balanced budget, the Conservative government adopted major tax and spending measures to reduce the deficit. The combination of these policies—which have been continued under the current Labor government—with a strong economy has brought the United Kingdom's budget back into a small surplus position in fiscal year 1998-99. (See figure 36.)

¹Unless otherwise noted, the term surpluses/deficits refers to the Public Sector Net Cash Requirement (PSNCR), formerly known as the Public Sector Borrowing Requirement (PSBR). The United Kingdom's fiscal year runs from April 1 to March 31.

Figure 36: Surpluses/Deficits in the United Kingdom, 1980-81 to 1998-99



Note: The surplus/deficit measure is the Public Sector Net Cash Requirement (PSNCR).
Source: The United Kingdom Treasury Department.

The Labor government that took office in 1997 developed a new framework for fiscal policy intended to prevent a return to the kind of severe "boom and bust" fiscal cycle that occurred in the late 1980s and early 1990s. The government enacted a statute requiring a Code for Fiscal Stability, which sets out the framework for developing fiscal strategy. As required by the Code, the current government has stated that its fiscal policy will be guided by two rules: (1) the "golden rule," under which borrowing will not be used to finance current spending (i.e., total spending excluding investment); and (2) the "sustainable investment rule," which promises to keep net public debt as a share of GDP at a "stable and prudent" level. Both rules are to be

applied over the economic cycle, allowing for fiscal fluctuations based on current economic conditions. Under these rules, the government's fiscal policy allows for deficits to be used to finance investment spending, provided that the debt burden is maintained at a sustainable level.

Background

The United Kingdom is a unitary state composed of England, Scotland, Wales, and Northern Ireland. The United Kingdom has two main levels of government: the central government and local authorities. The central government is the dominant fiscal decision-maker with direct or indirect control over most government revenue and spending, while local authorities are primarily responsible for service delivery in education, housing, and social services.²

The government is a parliamentary system, with a Parliament composed of two chambers—the House of Lords and the House of Commons. The House of Lords (approximately 1,300 members) has limited powers in the legislative process and virtually no power on budget matters. The House of Commons (659 members) is elected and is responsible for the passage of legislation and scrutiny of public administration. The government is headed by a Prime Minister, who is the leader of the majority party in the House of Commons, and an appointed Cabinet of about 20 members, who are also Members of Parliament.

A general election is held at least once every 5 years. Two parties have long dominated British politics: the Labor Party and the Conservative Party. The current Labor government, headed by Prime Minister Tony Blair, was elected in 1997. Labor has a large legislative majority with 415 seats to the Conservatives' 162 seats.³ Prior to Labor's electoral victory in 1997, the Conservatives had held power since 1979. The Conservative governments were led by Prime Minister Margaret Thatcher from 1979 to 1990 and Prime Minister John Major from 1990 to 1997.

²The Government is in the process of devolving power to Scotland, Wales, and Northern Ireland. Powers were officially transferred to the Scottish Parliament and the National Assembly for Wales on July 1, 1999. The Northern Ireland Assembly met for the first time on July 1, 1998, but the United Kingdom Parliament has not yet transferred power to the Assembly.

³The number of seats is as of April 1, 1999.

The United Kingdom's
Economy

The United Kingdom's economy is less than 16 percent of the size of the United States' economy. The United Kingdom is more dependent on trade than the United States, with exports accounting for over 22 percent of GDP in 1996—compared to about 8.5 percent for the United States.

Recent Economic History

Over the past two decades, the United Kingdom has experienced periods of both deep recession and robust growth. After recovering from a major recession between 1979 and 1981, the economy grew at an annual average rate of more than 3 percent in real terms for nearly a decade. Growth was especially robust in the late 1980s. However, inflation, which had fallen significantly from double-digit levels in the early 1980s, began to show signs of rising. During 1988 and 1989, the government responded to the growing inflationary pressure by imposing a series of interest rate hikes. In 1990, the economy went into a recession that lasted until 1992. The economy began to recover in the second half of 1992 and has continued to expand since then. (See figure 37.)

Figure 37: GDP Growth in the United Kingdom, 1980 to 1998



Source: The United Kingdom Office of National Statistics.

The economy often has a powerful impact on a government's finances. For example, recessions typically reduce a government's tax revenues while increasing spending on programs like unemployment insurance. During the past two decades, changes in the United Kingdom's fiscal position have closely followed the economic cycle. Deficits gave way to surpluses during the 1980s expansion. Then, with the onset of the recession in the early 1990s, deficits reemerged before steadily declining in tandem with the sustained economic growth of the mid- to late 1990s.

Controlling inflation has been the chief goal of monetary policy over the past two decades. Until 1997, monetary policy was under the control of the

government. When the Labor Party assumed power in 1997, it delegated the power to set interest rates to the Bank of England—the United Kingdom's central bank. Under this system, the Government sets an inflation target that the Bank has to achieve and the Bank's Monetary Policy Committee decides how to meet the target.

The Budget Process

The governing political party effectively controls the entire budget process. Spending and tax decisions are made primarily within the Treasury.

Under the previous Conservative government, the Treasury controlled budget resources by setting targets for total spending and establishing cash limits for specific programs. The broad spending target, known as the Control Total, covered about 85 percent of the budget. It excluded interest, privatization proceeds, and the portion of social security directly affected by the economic cycle (e.g., spending for unemployment compensation). Within the Control Total, specific cash limits were set for individual programs. Spending plans were made for a 3-year period but were reviewed annually. A reserve fund controlled by the Treasury was included in the spending total and departments were allowed to request funds from the reserve to cover program spending in excess of the cash limits.

The current Labor government has modified the budget planning process. Under the new system, spending is split into two categories with separate control mechanisms. Each category covers about 50 percent of total spending. The first category is subject to Departmental Expenditure Limits (DELs), which are set for 3 years and, unlike in the previous process, will generally not be reviewed annually. The second category of spending is referred to as Annually-Managed Expenditure (AME) and covers spending that is more difficult to control. Its largest components are social security benefits, interest, and local government expenditure. Spending covered by AME will be subject to annual review and considered as part of total spending for purposes of meeting the government's fiscal goals. The budget still has an annual reserve, but it is significantly smaller than in the past. This reserve is intended more for emergency spending than as a source of supplemental funds for agencies.

Another process change under the Labor government is the greater emphasis given to distinguishing between current and capital spending. For spending that is subject to DELs, there are separate current and capital limits. The government also plans to adopt a form of accrual budgeting, called Resource Accounting and Budgeting (RAB), that the previous

government originally proposed in the mid-1990s. RAB is being adopted to improve the measurement of the costs of government activities and to clarify the distinction between current and capital spending.

Measuring Fiscal Position

Prior to 1998, the main measure of the surplus/deficit was the public sector net cash requirement (PSNCR), referred to at the time as the public sector borrowing requirement (PSBR). The PSNCR includes receipts and expenditures at all levels of government, including privatization proceeds, and is similar to the United States' unified budget. Privatization proceeds provided an additional source of revenue during the 1980s and part of the 1990s. The Conservative governments often presented their fiscal projections with and without privatization proceeds.

Under the Labor government, the Treasury has switched to public sector net borrowing (PSNB) as the main overall budget measure.⁴ PSNB differs from the PSNCR by excluding privatization proceeds and other financial transactions.⁵ While these measures have varied substantially in the past, Treasury projects that they will be very similar over the next several years, with differences ranging from 0.1 to 0.4 percent of GDP. The PSNB measure is a comprehensive measure of revenue and spending. It includes, for example, local government and capital spending budgets. In 1998, the government changed its budget measurement to conform to the 1995 European System of Accounts in order to facilitate comparisons with other European Union countries. The effect of this change was to slightly raise projected PSNB over the 5-year forecast period.

In addition to the PSNB measure, the Treasury also emphasizes the "current" surplus/deficit and the public sector net debt to GDP ratio, which are used to assess performance against the golden rule and the sustainable investment rule respectively.⁶ PSNB is equal to the current surplus/deficit minus net investment spending.⁷ The public sector net debt to GDP ratio is

⁴Although it is given less emphasis, the PSNCR is still reported.

⁵Other financial transactions include loans made by the public sector and accruals adjustments, which reflect the precise timing of payments.

⁶The net debt measure is net of certain liquid assets.

⁷Net investment excludes depreciation and asset sales.

used to monitor the government's progress at keeping the debt burden under control.

Fiscal History of the United Kingdom, 1980s and 1990s

The United Kingdom experienced persistent budget deficits from the mid-1970s to the mid-1980s. Beginning in 1979 when a new government came to power, deficit reduction efforts combined with several years of strong economic growth led to a 4-year period of surpluses beginning in fiscal year 1987-88. The government's fiscal policy during its surplus period was a gradual return to balance. A recession beginning in 1990 led to a return to budget deficits, which grew quickly, peaking at 7 percent of GDP in fiscal year 1993-94. The government responded with renewed efforts to reduce budget deficits. A new government came to power in 1997 and continued the previous government's deficit reduction efforts, leading to a small surplus in fiscal year 1998-99. This government has put in place a new framework to guide fiscal decision-making. Under this framework, the government has set as its fiscal policy to increase investment spending without increasing the debt burden.

Deficit Reduction Efforts Plus Strong Economic Growth Led to Budget Surpluses in the Late 1980s and Early 1990s

From the mid-1970s to the mid-1980s, the United Kingdom experienced a period of persistent budget deficits. When Margaret Thatcher's Conservative government came to power in 1979, it emphasized a commitment to lower deficits, spending restraint, and a reduced tax burden. After substantial deficit reduction efforts and several years of solid economic growth, the United Kingdom reached surplus in fiscal year 1987-88.

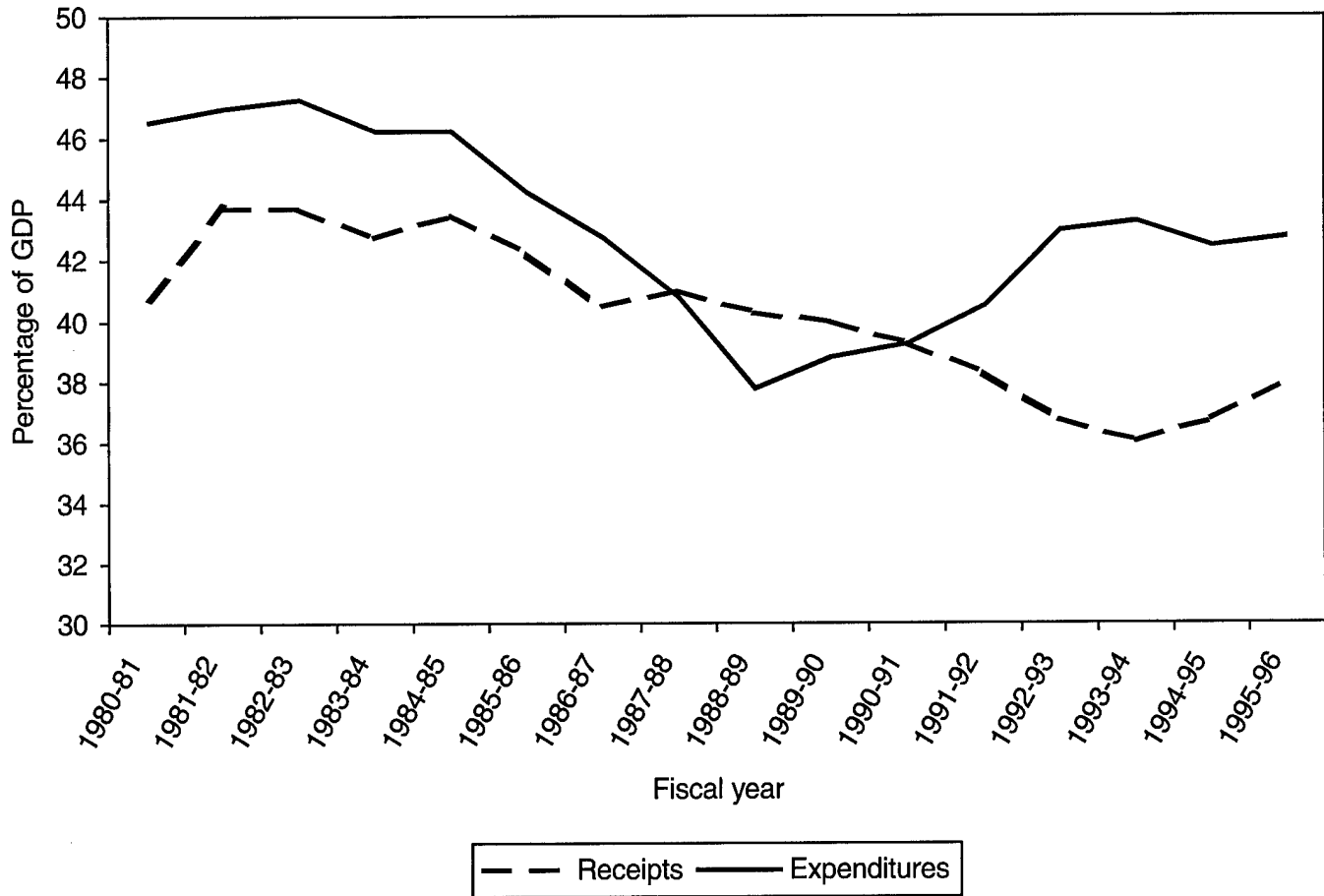
Appendix VI
United Kingdom

The success of deficit reduction was due primarily to spending restraint, although increased revenue also contributed. (See figure 38.) During the decade, annual real growth in total spending averaged 1.3 percent—a significant drop from the average 1970s level of 3.3 percent. Program spending was cut in the areas of transportation, trade and industry, and housing. Investment spending was scaled back significantly, as was the public sector workforce. The government also reduced its current and future pension expenditures by changing the indexing of the basic benefit from wages to prices and cutting future benefits in the earnings-related pension program. While revenue declined as a share of GDP during the 1980s, increased revenue from tax changes, economic growth, privatizations, and oil revenue all contributed to the success of deficit reduction.⁸

⁸For further details on the United Kingdom's deficit reduction efforts, see *Deficit Reduction: Experiences of Other Nations* (GAO/AIMD-95-30, December 13, 1994), pp. 191-215.

Appendix VI
United Kingdom

Figure 38: Receipts and Expenditures in the United Kingdom, 1980-81 to 1995-96



Source: United Kingdom Treasury Department.

The economy was growing rapidly when the budget entered surplus—over 4 percent per year from 1986 through 1988. According to recent estimates, this growth caused the United Kingdom's economy to exceed the level of output estimated to be consistent with stable inflation. The United Kingdom was experiencing an economic boom. Wages and salaries were growing rapidly, housing prices were soaring, and personal savings were declining. These factors helped drive substantial growth in consumption. Imports also increased at a fast pace, propelling the trade balance into deficit.⁹

Government Aimed to
Gradually Phase Out Budget
Surpluses

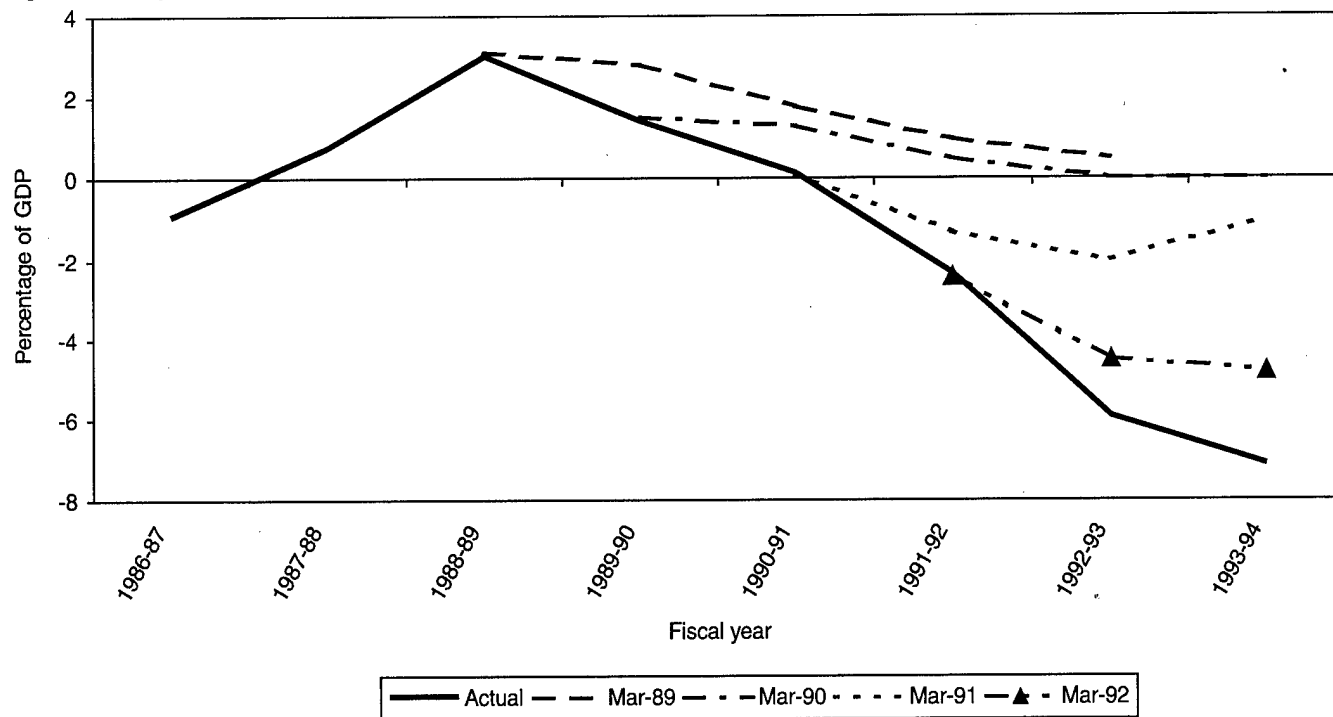
When the first surplus materialized, the government adjusted its fiscal strategy from a focus on deficit reduction to attempting to gradually phase out surpluses. For example, in the 1988-89 budget, the first budget prepared during the surplus period, the government adopted a goal of balancing the budget over the medium term, which meant phasing out the surplus. The government explained its goal as follows: "[A balanced budget] is a prudent and cautious level and can be maintained over the medium term. It also provides a clear and simple rule, with a good historical pedigree."

The fiscal year 1988-89 budget projected that after a small surplus in 1988-89, the medium-term goal of balance would be reached in the following year and maintained over the rest of the forecast horizon.¹⁰ However, the 1988-89 surplus turned out to be much larger than expected, and in the fiscal year 1989-90 budget the government anticipated a more gradual elimination of surpluses over several years. However, as the economy slowed and slipped into recession, the surplus decreased more rapidly than expected. Beginning with the 1989-90 budget, the Treasury's estimates were consistently too optimistic. (See figure 39.) By fiscal year 1990-91, the budget had returned to approximate balance, and deficits reemerged the following year.

⁹The trade balance is a measure of the difference between a nation's exports and imports.

¹⁰During the late 1980s, the forecast period was 4 years—the budget year plus 3 years. In the fiscal year 1992-93 budget, the Conservative government extended its forecast period to 5 years—the budget year plus 4 years. The Labor government uses this same forecast period.

Figure 39: Projected Surpluses/Deficits and Actual Results in the United Kingdom, 1986-87 to 1993-94



Note: Surplus/deficit measure is the public sector net cash requirement.

Source: United Kingdom Treasury Department.

Because of the government's policy to return to balance, the political debate during the surplus period focused not on whether to run surpluses but on how to use extra resources for new policy initiatives. The opposition Labor Party favored more spending on health and social services. However, the government chose to cut taxes significantly while also allowing for some increased spending. The government's spending increases were allocated for priority areas such as health, law and order, defense, education, roads, and the disabled. In general, however, spending was decreasing as a percent of GDP—from about 41 percent in fiscal year 1987-88 to about 39 percent in 1990-91. These policy changes in the late 1980s supported the government's goal of phasing out budget surpluses, but they also contributed to the large deficits that unexpectedly emerged in the early 1990s. The following is a year-by-year summary of the major budget actions during the United Kingdom's surplus era.

Fiscal Year 1988-89 Budget

Tax-cutting was an important priority for Prime Minister Thatcher's government, and it continued to dominate the fiscal agenda during the surplus period of the late 1980s. The fiscal year 1988-89 budget introduced tax cuts with a first-year impact of about £4 billion, around 1 percent of GDP.¹¹ The tax cut package mainly consisted of reductions in personal income taxes with a cut in the lowest marginal rate from 27 percent to 25 percent and in the top rates to a maximum of 40 percent.

The budget clearly spelled out the expected impact of tax cuts on the government's fiscal position. The budget estimated that the surplus would be about £7 billion for fiscal year 1988-89 without the tax cuts and about £3 billion in 1988-89 with them. The government explained the remaining surplus by saying it could have chosen to cut taxes by a larger amount, but that because of its gradualist approach to fiscal policy, "only part of [the] room for tax reductions has been used."¹²

On the spending side of the budget, the government's main goal throughout the 1980s and 1990s was to reduce total spending as a share of GDP. Since the early 1980s, spending as a share of GDP had fallen substantially and the 1988-89 budget supported a continuation of this trend, referring to continued spending restraint as "a vital element of the government's economic strategy." Real (inflation-adjusted) spending—excluding privatization proceeds—was projected to grow by less than 1 percent per year from fiscal years 1986-87 through 1990-91.¹³ At the same time, the budget provided some increased spending for priority services such as health, law and order, defense, education, and capital investment. These increases could be made while meeting the government's objective of reducing spending as a share of GDP in part because, as GDP expanded rapidly, reduced interest payments on the debt helped restrain spending growth.

¹¹The data on tax changes presented in this appendix are measured against an indexed tax base. The tax system in the United Kingdom is automatically indexed for inflation each year unless Parliament decides differently.

¹²*Financial Statement and Budget Report 1988-89*, HM Treasury (United Kingdom), p. 11.

¹³Privatization proceeds are treated as negative spending; therefore, these proceeds reduce total spending.

Fiscal Year 1989-90 Budget

The fiscal year 1989-90 budget was prepared during what, in retrospect, turned out to be the high water mark of the surplus period. The 1988-89 surplus came in at about 3 percent of GDP—compared to a projected borrowing requirement of 1 percent of GDP. This surprising fiscal performance can be explained by 3 main factors: (1) a strong economy that resulted in rapid revenue growth and lower spending for income support programs, (2) higher-than-expected inflation, which also boosted revenues,¹⁴ and (3) a high volume of privatization proceeds. This favorable position suggested to policymakers that surpluses were more persistent than earlier anticipated, and they budgeted accordingly. While the overall goal of phasing out the surplus and balancing the budget remained the same, the 1989-90 budget projected a surplus of similar size to the previous year—about 3 percent of GDP—with smaller surpluses through the 1992-93 fiscal year.

Budget plans for the 1989-90 fiscal year were consistent with the government's goals of cutting taxes and reducing spending as a share of GDP. The main tax changes were cuts in National Insurance Contributions and, for that year, non-indexation of most excise taxes.¹⁵ The total tax package was estimated to cost about £2 billion in the first year, about 0.5 percentage points of GDP. Spending plans again called for restraint, with the budget projecting a continuing decline in spending as a percentage of the economy.

Fiscal Year 1990-91 Budget

The actual fiscal year 1989-90 surplus was only 1.4 percent of GDP—roughly half as large as anticipated. While the economy had already begun to slow in 1989, this was not a major driver of the smaller surplus since revenue collections, particularly for corporate taxes, are subject to a time lag. Rather, the shrinking surplus stemmed from lower privatization proceeds, higher capital spending by local authorities, and a greater number of people switching to private pensions than expected, which reduced National Insurance Contributions.¹⁶

¹⁴Even in indexed tax systems, higher inflation produces more tax revenue because it increases the size of taxable incomes.

¹⁵The National Insurance Contribution is a payroll tax that covers a variety of social programs, including public pensions.

¹⁶Under the government's 1986 pension reform, workers who switch from the public pension system to a private plan receive a rebate of part of their National Insurance Contribution.

The fiscal year 1990-91 surplus was projected to be about 1.3 percent of GDP, approximately the same size as the fiscal year 1989-90 surplus. Compared to the prior two budgets, tax initiatives were relatively modest and were projected to result in a net increase in revenues. Spending was expected to grow at the same rate as the economy, with additional resources for priority areas such as health, transportation, the disabled, and lower income families. For fiscal year 1991-92, a smaller surplus was projected followed by balanced budgets in the last 2 years of the forecast horizon. However, with the slower growth of 1989 turning into a recession in 1990, the actual result for fiscal year 1990-91 was a small surplus, marking the end of the surplus period.

The United Kingdom's period of surpluses substantially reduced the nation's debt both in nominal terms and as a share of GDP. Over the 3 years from fiscal years 1986-87 through 1989-90, the debt declined from £172 billion to £150 billion, and the debt to GDP ratio dropped from over 40 percent to less than 30 percent. Along with the declining debt burden, the government's interest expenditures as a share of total spending fell from 11 percent to 9 percent.

Large Deficits Appear in Early 1990s

By the time the fiscal year 1991-92 budget was released, the economy was clearly in recession, and it was apparent that deficits were back on the horizon. The government retained its goal of a balanced budget over the medium term, but now it estimated that this goal would not be reached again until fiscal year 1994-95, the last year of the projection period. Actual deficits over the next several years were much higher than the Treasury's estimates, peaking at more than 7 percent of GDP in fiscal year 1993-94, and the budget did not return to balance until near the end of the decade. In the 1993-94 budget, the government acknowledged the worsening situation by projecting that it would not reach a balanced budget within the forecast period.

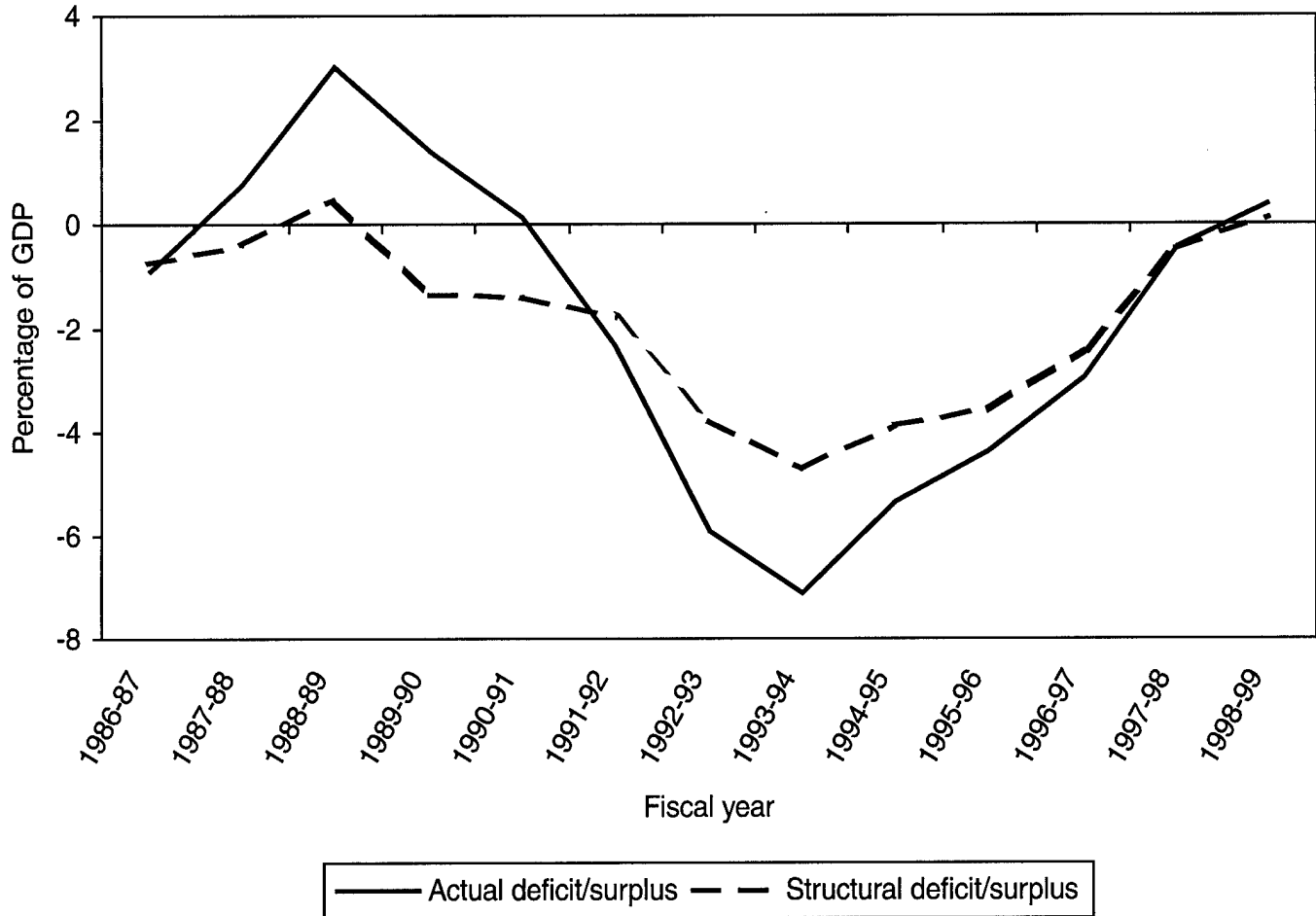
Policy decisions interacted with the recession to fuel rising deficits. A Treasury analysis of spending from fiscal year 1988-89 to 1992-93 found that policy initiatives were a significant factor in explaining a substantial increase in real program spending over the period. For example, the 1991-92 budget contained cuts in corporate taxes and the 1992-93 budget cut the basic rate of income tax on a portion of taxable income. On the spending side, the 1991-92 budget increased the child benefit, which had been frozen for 4 years, and reestablished a policy of indexing the benefit to inflation. The fiscal year 1992-93 budget provided increased spending for health care and transportation. A number of officials and experts that we interviewed attributed the loosening in fiscal policy in 1991 and early 1992 at least in part to the upcoming general election.¹⁷ A statistical analysis conducted by a British think tank on spending during the period is consistent with this interpretation.

Economic Estimates Presented a
Misleading Picture of Fiscal
Strength

To explain the deteriorating situation in the early 1990s, it is useful to start with the perceptions of fiscal strength in the late 1980s. The surpluses of the late 1980s provided a misleading picture of the United Kingdom's fiscal condition. With the benefit of hindsight, fiscal analysts and policymakers with whom we spoke in the United Kingdom generally agree that the budget surpluses were largely due to the strength of the economy during what turned out to be the peak period of the business cycle. The Treasury now estimates that when the United Kingdom realized a surplus of 3 percent of GDP in fiscal year 1988-89—its largest of the period—the structural budget was only modestly in surplus. (See figure 40.)

¹⁷The Conservative government under Prime Minister John Major was reelected in April 1992.

Figure 40: Actual and Structural Surpluses/Deficits in the United Kingdom, 1986-87 to 1998-99



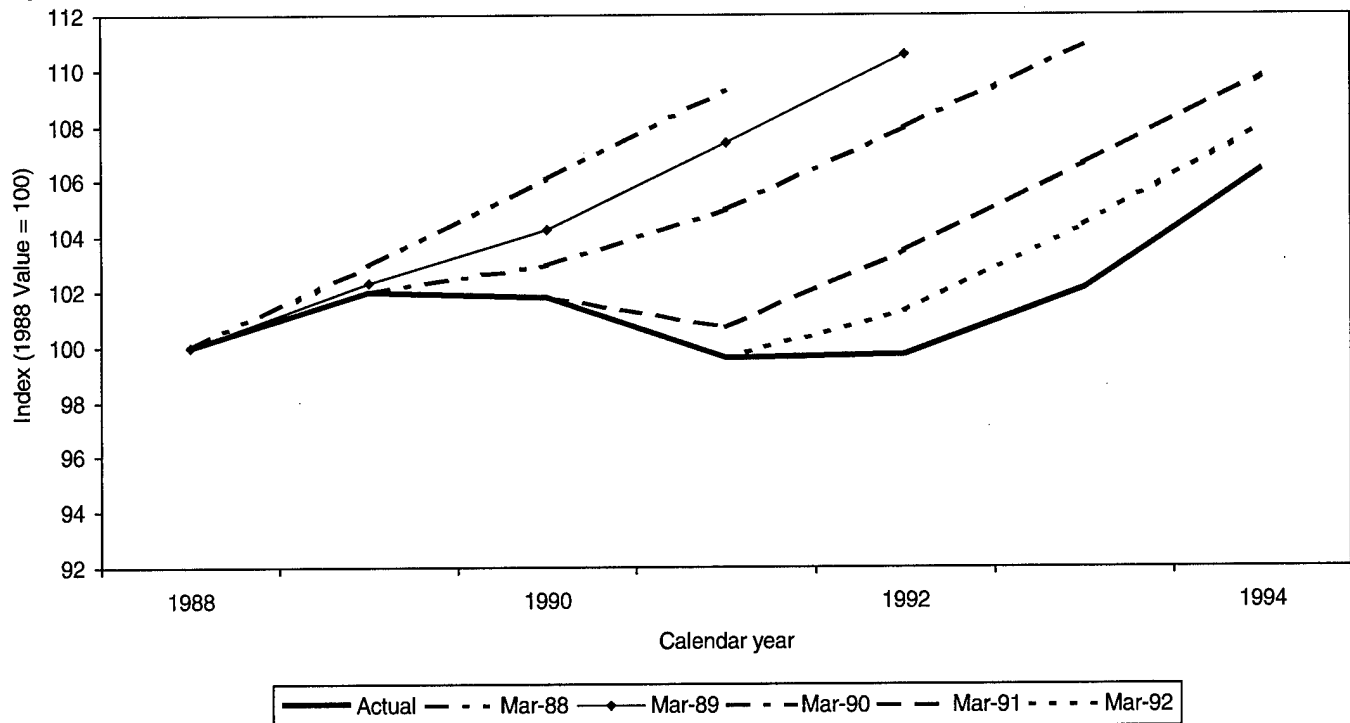
Note: Surplus/deficit measure is the public sector net cash requirement.

Source: The United Kingdom Treasury Department.

While the Treasury did produce structural budget estimates in the late 1980s, these estimates were not a major focus of fiscal policy decision-making. Officials told us that policymakers did not really distinguish between cyclical and structural results; instead, they tended to believe that "a surplus is a surplus." However, even if structural estimates had been taken more seriously, they might not have helped much because the estimates made at that time were off the mark. The Treasury, along with some independent analysts at the time, underestimated the extent to which

the economy was growing above its trend level. So, according to the projections of the time, it was believed that the United Kingdom's economy could continue growing steadily without generating an increase in inflation. This forecasting error was a major reason why, beginning in the late 1980s, the Treasury's budget forecasts proved overly optimistic. For example, the Treasury's estimates of real economic growth were consistently too high during the late 1980s and early 1990s. (See figure 41.)

Figure 41: Projections of Real GDP Compared to Actual Results in the United Kingdom, 1988 to 1994



Source: The United Kingdom Treasury Department.

Policy Choices Contributed to Renewed Deficits

In general, policymakers overestimated the strength of the government's finances. The Conservative government assumed that the surpluses in the late 1980s largely reflected a structural improvement driven by sustainable economic growth. This assumption may have contributed to the decision to enact significant tax cuts. With hindsight, analysts contend that this decision turned out to be an inappropriate loosening of fiscal policy.

Treasury now estimates that the fiscal year 1988-89 budget with its substantial tax cuts contributed to a significant increase in the structural deficit.

In the early 1990s, increased spending also contributed to a rising structural deficit. In an analysis conducted at that time, the Treasury concluded that, from fiscal years 1988-89 through 1992-93, spending growth rose substantially for most programs. Total program spending grew at an annual average rate of 3.8 percent during this period compared to less than 1 percent for the previous 6 years. The analysis concluded that policy choices contributed to this growth over and above the impact of the recession. For example, average real growth in health spending of 4.3 percent during this period reflected policymakers' response to rising public demand for services. In addition, the government increased transportation spending by nearly 10 percent per year in real terms, partly to alleviate road congestion and finance other major investment projects.

The Economy's Impact on Fiscal Position

While policy decisions clearly contributed to the growing deficits, the recession was also a major factor. Estimates of its impact vary. Data from a recent Treasury analysis suggest that the economic cycle was responsible for a little more than 50 percent of the deterioration, with policy choices accounting for the rest. Two earlier studies by other analysts reached similar conclusions. However, in its 1994 survey of the United Kingdom, the Organization for Economic Cooperation and Development (OECD) estimated that the economy was responsible for about two-thirds of the weakening in the fiscal position.

Privatization Proceeds Also Affected Fiscal Position

Privatization proceeds also had a noticeable effect on the United Kingdom's fiscal position during the late 1980s and early 1990s. Revenue from privatization (which was counted in the budget as negative spending) peaked as a share of the economy in fiscal year 1988-89 at about 1.5 percent, dipped in fiscal years 1989-90 and 1990-91, rose substantially in fiscal year 1991-92 and then began to decline. Given this path, privatization proceeds did contribute significantly to the period of surpluses but were only a minor factor in explaining the rising deficits of the early to mid-1990s. Although the government recognized the one-time nature of privatization by showing its expenditure projections with and without privatization proceeds, its fiscal target of a balanced budget included such proceeds.

Deficit Reduction in the Mid- to Late 1990s

The government responded to the rising deficits of the early 1990s by increasing taxes and restraining spending growth. This policy of fiscal restraint was continued by the Labor government elected in April 1997. These efforts have succeeded—the deficit has fallen in every fiscal year since 1993-94—and the budget is now approximately in balance. During this period, revenue as a share of GDP rose by over 3 percentage points while spending declined by over 4 percentage points.¹⁸ An OECD analysis concluded that the United Kingdom's fiscal progress between 1993 and 1997 is "among the most impressive" of the OECD's member countries.¹⁹

The major deficit reduction efforts began with the fiscal year 1993-94 and 1994-95 budgets. Both budgets included significant revenue raising actions, including a freeze on income tax allowances, increased excise taxes, and restrictions on mortgage interest relief. These actions are estimated to have raised revenues by more than 2 percent of GDP. Since taking power in 1997, the current government has also raised taxes.

Along with tax increases, the budgets of the mid-1990s contained substantial spending restraint. Major reductions initiated in these budgets included a freeze on departmental operating costs (including salaries) and cutbacks in defense and housing programs. Capital investment and health care have also been subject to significant spending restraint. While continuing this policy of keeping total spending in check, the Labor government has pledged to significantly increase spending on capital investment and health care.

The Current Government's Fiscal Policy Is Based on Lessons From Past Experiences

The current government has developed a new framework for fiscal policy that reflects "lessons learned" from the United Kingdom's past experiences.²⁰ The fiscal strategy emphasizes a greater focus on the structural budget, a more explicit distinction between current and capital spending, and firm multi-year spending ceilings that will not be subject to annual review. The Labor government has also stressed transparency and

¹⁸These changes are based on data that exclude financial transactions.

¹⁹*OECD Economic Surveys: United Kingdom*, 1998, p. 49.

²⁰The new monetary policy framework is also an important part of the Labor government's overall economic strategy. Giving control of interest rates to the Bank of England is expected to improve the prospects for keeping inflation in check and preventing sudden and rapid adjustments in interest rates.

openness so that the public can easily evaluate the government's goals and its progress in meeting them. During the 1997 election, Labor emphasized its commitment to a prudent fiscal policy by adopting the Conservatives' spending targets for the first 2 years of the new Parliament and pledging not to raise either the basic or top income tax rate throughout the full Parliamentary term. However, the Labor government does not currently call for surpluses as part of its fiscal policy.

Labor's Code for Fiscal Stability

Labor has established a statutory basis for its fiscal policy approach with a new law requiring the government to issue a Code for Fiscal Stability. The law's purpose is to make fiscal decision-making more transparent and enhance accountability by requiring the government to present a fiscal strategy and meet certain reporting requirements. The statute itself is very general, allowing the incumbent government wide discretion in developing a specific fiscal strategy. The statute lays out 5 principles to guide fiscal policy: transparency, stability, responsibility, fairness, and efficiency. The statute also requires the issuance of several reports with details of the government's fiscal plans.

The current Labor government's fiscal strategy is guided by two rules: (1) the "golden rule," under which borrowing will not be used to finance current spending (i.e., total spending excluding investment); and (2) the "sustainable investment rule," which promises to keep net public debt as a share of GDP at a "stable and prudent" level. Both rules are to be applied over the economic cycle, allowing for fiscal fluctuations based on current economic conditions.

The golden rule is intended to ensure control of public finances while allowing for deficit financing of capital investment, net of depreciation and asset sales. The government defines investment as "physical investment and grants in support of capital spending by the private sector."²¹ Investment spending was significantly restrained under the Conservative government's deficit reduction efforts, and several people that we interviewed agree that investment needs to be increased. The Labor government has made boosting public investment a major priority, proposing to nearly double it as a share of the economy—to 1.5 percent of GDP—over the course of the current Parliament. A Treasury official told us

²¹*Fiscal Policy: current and capital spending*, HM Treasury (United Kingdom), 1998, p. 7, footnote 2.

that this increase has been viewed as roughly the amount needed to cover the underfunding of capital over the past several years.

While investment spending is a priority, the sustainable investment rule is intended to ensure that financing such spending does not result in an imprudent rise in debt. According to a Treasury official, the government's debt to GDP target of less than 40 percent was chosen based on analysis showing that a net debt to GDP ratio of around 40 percent is sustainable in the long term. The government has indicated that, other things being equal, it is desirable to reduce public sector net debt to below 40 percent.

Taking both fiscal rules into account, the Labor government's overall fiscal policy allows for running small budget deficits. In its fiscal year 1999-2000 budget, the Treasury estimated that the United Kingdom would register a small surplus for public sector borrowing in fiscal year 1998-99, and it projected small deficits for the next 5 years.

To help meet its fiscal objectives, the Labor government has completed a comprehensive assessment of existing programs with plans to conduct similar reviews every 3 years. This review process is designed to align existing programs with the government's priorities and generate ways to improve efficiency. Results of the first review were published in the summer of 1998. Based on the results, the government has targeted real growth in current spending at 2.25 percent per year over the remainder of Parliament's term; the review also called for net investment to double as a share of GDP. Within the spending total, the government has set 3-year ceilings for each department with separate ceilings for capital and current spending.²²

The current government's fiscal policies have been popular but not without controversy. For example, Conservative Party officials we met with worried that under the golden rule it would be easy for the government to redefine capital spending in order to meet the rule. In addition, they believe that allowing for borrowing for capital investment is not always prudent because the financial return on government investments is questionable. The Conservative Party officials also said the current government ought to aim to repay or reduce the debt as a percentage of GDP. The officials then

²²As noted earlier, the 3-year limits apply to about half of total spending. The other half of spending is reviewed annually.

Incorporating the Economic Cycle Into Fiscal Planning

added that the Conservatives' objective would be to balance the budget over the cycle and bring down the debt as a percentage of GDP.

A sharper focus on the economic cycle is a general feature of the Labor government's policy that explicitly reflects the lessons learned from the past. A recent Treasury report explains the importance of taking the cycle into account.

"Experience has shown that serious mistakes can occur if purely cyclical improvements in the public finances are treated as if they represented structural improvements, or if a structural deterioration is thought to be merely a cyclical effect. The Government therefore pays particular attention to cyclically-adjusted indicators of the public sector accounts."²³

Incorporating the effects of the economic cycle into policy planning requires an estimate of several key variables, including the actual and trend levels of GDP and the trend rate of GDP growth. Trend growth is an estimate of the maximum rate at which an economy can grow over the long term without causing inflationary pressure. Actual and trend growth estimates are used to prepare an estimate of the structural budget deficit/surplus, i.e., the underlying condition of the budget adjusting for the effects of the economic cycle. In the past, the Treasury did prepare estimates of the structural budget position, but it did not publish this information. As part of the Labor government's commitment to greater openness, the Treasury now publishes structural estimates. The Treasury cautions that while all economic and budget projections are subject to large errors, estimates of the structural position are even more tenuous.

The government states that it uses a cautious assumption for trend economic growth of 2.25 percent in its budget formulation. To obtain an independent review, the government asked the National Audit Office (NAO) to evaluate the trend growth assumption.²⁴ The NAO concluded that the Treasury's assumption for trend growth was reasonable. For an additional degree of caution in its structural estimates, the Treasury also presents a more pessimistic projection. This projection assumes that the economy is further above trend output than in the main estimate, meaning

²³ *Stability and Investment for the Long Term: The Economic and Fiscal Strategy Report 1998*, HM Treasury (United Kingdom), June 1998, p. 45.

²⁴ The government also asked the NAO to review several other assumptions, including the unemployment rate and the proportion of national income generated by capital and labor.

that future growth will likely be lower as the economy returns to the underlying trend.

The United Kingdom's Long-term Outlook

The population of the United Kingdom is aging, although at a slower rate than other major industrial countries. Due to the post-World War II baby boom and increases in life expectancy, the ratio of workers to retirees in the United Kingdom is projected to drop from over 3 to closer to 2 between 1998 and 2040. While several analysts that we interviewed expressed some concern about population aging, they were fairly sanguine about its likely impact on the government's fiscal situation, especially when compared to the outlook for other nations. While one factor in the United Kingdom's comparatively better outlook is slower population aging, another important reason is the major pension reforms enacted over the past two decades. These reforms have significantly reduced the government's future commitments.

While pension spending appears to be under control, population aging is expected to increase pressure on health care spending in the future. According to a Treasury analysis, demographic factors could add about 0.7 percentage points to the annual growth rate of public health spending, which accounted for about 5.7 percent of GDP in 1997, over the next three decades. However, analysts we interviewed from the United Kingdom's National Health Service told us that they consider population aging to be a less significant source of future cost pressure than improved technology and public expectations.

The current Labor government has acknowledged the need to use a long-term fiscal outlook to evaluate the sustainability of future policy and consider intergenerational equity. Specifically, the Code for Fiscal Stability requires the government to publish budget projections for a period of at least 10 years. In the March 1999 budget, the Treasury published 30-year projections that show that current policy is sustainable under their main assumptions. It is important to note, however, that the government has recently announced several policies—such as welfare, pension, and labor market reforms—to help ensure the sustainability of public finances in the long term. In addition to its own long-term analysis, the Treasury is supporting research on generational accounts that is being conducted by the independent National Institute of Social and Economic Research.

Conclusion

The United Kingdom experienced a period of budget surpluses in the late 1980s and early 1990s that was largely the product of a booming economy. Upon achieving surplus, the United Kingdom's fiscal strategy was to return to a balanced budget over the medium term. Influenced by overly optimistic budget projections, the Conservative government in power at that time chose to cut taxes substantially and increase spending as part of a strategy of phasing out budget surpluses. As the British economy slipped into recession in the early 1990s, the fiscal situation deteriorated rapidly and large deficits emerged. These deficits resulted from both the recession and policy choices made during the period. With the benefit of hindsight, the current Labor government focuses more on the budget's structural position to adjust for the impact of the economic cycle. The Treasury now publishes estimates of the budget's structural position and includes a pessimistic projection along with its baseline forecast to help convey a sense of the risks involved if budget forecasts prove overly optimistic. The United Kingdom achieved a small budget surplus in fiscal year 1998-99 due to deficit reduction efforts and a strong economy. The government's main fiscal policy is to maintain its net debt to GDP ratio at a "stable and prudent" level, allowing for some borrowing to finance capital investments.

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