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# 3-Step Analysis of Public Finances Sustainability: the Case of the European Union\*

*António Afonso<sup>\$</sup> and Christophe Rault<sup>#</sup>*

## Abstract

We use a 3-step analysis to assess the sustainability of public finances in the EU27. Firstly, we perform the SURADF specific panel unit root test to investigate the mean-reverting behaviour of general government expenditures and revenues ratios. Secondly, we apply the bootstrap panel cointegration techniques that account for the time series and cross-sectional dependencies of the regression error. Thirdly, we check for a structural long-run equation between general government expenditures and revenues via SUR analysis. While results imply that public finances were not unsustainable for the EU panel, fiscal sustainability is an issue in most countries, with a below unit estimated coefficient of expenditure in the cointegration relation.

Keywords: fiscal sustainability, EU, panel cointegration.

JEL Classification Numbers: C23, E62, H62.

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## **1. Introduction**

Studies on the sustainability of public finances regarding the European Union usually restrict themselves to the set of EU Member States before the 1 May 2004 enlargement. According to our knowledge, this is the first fully fledged panel analysis of fiscal sustainability encompassing this enlarged set of EU countries. The choice of such group of countries is usually prompted by the lack of longer comparable time series data for the new EU Member States. In this paper we assess the sustainability of public finances, taking advantage of non-stationary panel data econometric techniques and the Seemingly Unrelated Regression (SUR) methods, covering several sub-periods within the period 1960-2006 and also defining different country groupings for the 27 members of the EU.

Even if there is no single fiscal policy in the EU, panel analysis of the sustainability of public finances is relevant in the context of 27 EU countries seeking to pursue sound fiscal policies within the framework Stability and Growth Pact. Cross-country dependence can be envisaged either in the run-up to EMU or, for example, via integrated financial markets. Indeed, cross-country spillovers in government bond markets are to be expected, and interest rates comovements inside the EU have also gradually become more noticeable. On the other hand, and since fiscal sustainability certainly needs to be tackled at the country level, a country assessment is also necessary, being therefore useful to have as many time series observations as possible. In this context, the use of the Seemingly Unrelated Regression ADF (SURADF) panel integration test provides additional country specific results.

In the empirical literature, fiscal sustainability analysis based on unit root or cointegration tests has in the past been mostly performed for individual countries posing the problem of relatively short time series.<sup>1</sup> However, panel data methods have recently been used to assess fiscal sustainability, notably when testing for cointegration between general government expenditure and revenue – a relationship derived from the intertemporal government budget constraint. In this context panel unit root and panel cointegration analysis have been used notably by Prohl and Schneider (2006) for the EU, Westerlund and Prohl (2006), for OECD countries, and Afonso and Rault (2007a, b) for the EU. The single most cited rationale for using this approach is the increased power that may be brought to the cointegration hypothesis through the increased number of observations that results from adding the individual time series.

In this paper we use a 3-step empirical methodology to test for the sustainability of public finances in the EU. (i) The SURADF panel integration test from Breuer et al. (2002, 2006) is first implemented for the general government expenditures ( $G_{it}$ ) and revenues ( $R_{it}$ ) series as a ratio of GDP. To the best of our knowledge, this is the first empirical application of the test in the context of fiscal sustainability. This test accounts for cross-sectional dependence among countries and allows the researcher to identify how many and which countries of the panel have a unit root. (ii) For the countries for which  $G_{it}$  and  $R_{it}$  are found to be integrated of order one, we then carry out the panel bootstrap test of Westerlund and Edgerton (2007) that tests for the null hypothesis of cointegration between  $G_{it}$  and  $R_{it}$  against the alternative that there is at least one country for which these two variables are not cointegrated. This test relies on a sieve sampling scheme to account for the time series and cross-sectional dependencies of the regression

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<sup>1</sup> See, for instance, Hakkio and Rush (1991), Haug (1991), Quintos (1995), Ahmed and Rogers (1995) and Afonso (2005).

error. (iii) Finally, if cointegration is not found, sustainability of public finances is rejected, whereas if cointegration is found, the testing proceeds by checking with SUR estimations via the Zellner (1962) approach, for a unit slope on  $G_{it}$  in a regression of  $R_{it}$  on  $G_{it}$ . The latter is a necessary condition for the sustainability of public finances to hold.

The rest of the paper is organised as follows. Section Two briefly presents the analytical framework for fiscal sustainability. Section Three explains our econometric strategy, Section Four reports the empirical fiscal sustainability results for the European Union, following our 3-step analysis, and Section Five concludes.

## 2. Analytical framework for fiscal sustainability

The starting point for the analysis of the sustainability of public finances is the so-called present value borrowing constraint, which can be written for a given country as

$$B_{t-1} = \sum_{s=0}^{\infty} \frac{1}{(1+r)^{s+1}} (R_{t+s} - E_{t+s}) + \lim_{s \rightarrow \infty} \frac{B_{t+s}}{(1+r)^{s+1}}. \quad (1)$$

where  $E_t = GP_t + (r_t - r)B_{t-1}$ , with  $GP$  - primary government expenditure  $R$  - government revenue,  $B$  - government debt,  $r$  - real interest rate, assumed to be stationary with mean  $r$ . A sustainable fiscal policy needs to ensure that the present value of the stock of public debt goes to zero in infinity.

Using GDP ratios, with the GDP real growth rate,  $y$ , also assumed constant, we have

$$b_{t-1} = \sum_{s=0}^{\infty} \left( \frac{1+y}{1+r} \right)^{(s+1)} [r_{t+s} - e_{t+s}] + \lim_{s \rightarrow \infty} b_{t+s} \left( \frac{1+y}{1+r} \right)^{(s+1)}, \quad (2)$$

with  $b_t = B_t/Y_t$ ,  $e_t = E_t/Y_t$  and  $r_t = R_t/Y_t$ . When  $r > y$ , the solvency condition

$$\lim_{s \rightarrow \infty} b_{t+s} \left( \frac{1+y}{1+r} \right)^{(s+1)} = 0 \quad (3)$$

is needed to limit public debt growth.

From (1), and defining  $G_t = GP_t + r_t B_{t-1}$ , we have

$$G_t - R_t = \sum_{s=0}^{\infty} \frac{1}{(1+r)^{s+1}} (\Delta R_{t+s} - \Delta E_{t+s}) + \lim_{s \rightarrow \infty} \frac{B_{t+s}}{(1+r)^{s+1}} \quad (4)$$

With the no-Ponzi game condition,  $G_t$  and  $R_t$  must be cointegrated of order one for their first differences to be stationary. If  $R$  and  $E$  are non-stationary, and the first differences are stationary, then  $R$  and  $E$  are I(1) in levels. Thus, for (4) to hold, its left-hand side, in other words the budget balance, will also have to be stationary, which is possible if  $G$  and  $R$  are integrated of order one, with cointegration vector (1,-1). Therefore, assessing fiscal sustainability involves testing the cointegration regression:

$$R_t = a + bG_t + u_t \quad (5)$$

Naturally, and as explained by Afonso (2005), if one of the two variables is I(0) and the other is I(1) there may be a sustainability issue, and more precisely, this can not be tested via cointegration. On the other hand, it may also be the case that even with different orders of integration there are no sustainability problems if revenues are systematically above expenditures and the country consistently runs a budgetary surplus.

### **3. Econometric strategy**

#### **3.1. Methodological issues**

The literature on panel unit root and panel cointegration testing has been increasing considerably over the last fifteen years and it now distinguishes between the first generation tests (see Maddala, and Wu, 1999; Levin, Lin and Chu, 2002; Im, Pesaran and Shin, 2003) developed on the assumption of the cross-sectional independence among panel units (except for common time effects) The second generation tests (e.g. Bai and Ng, 2004; Smith et al., 2004; Moon and Perron, 2004; Choi, 2006; Pesaran, 2007) allow for a variety of dependence across the different units, and also panel data root tests that enable to accommodate structural breaks (e.g. Im and Lee, 2001). Moreover, the advantages of panel data methods within the macro-panel setting include the use of data for which the spans of individual time series data are insufficient for the study of many hypotheses of interest, have become more widely recognized in recent years. Other benefits include better properties of the testing procedures when compared to more standard time series methods, and the fact that many of the issues studied, such as convergence, purchasing power parity or the sustainability of public finances, lend themselves to being studied in a panel context.

Despite the fact that panel data unit root tests are likely to have higher power than conventional time series unit root tests by including cross-section variations (which make them very popular in applied studies), their results must, however, be interpreted with some caution, especially when applied to real exchange rate data or when testing for the sustainability of fiscal policy. In particular, as noted by Taylor and Sarno (1998) and Taylor and Taylor (2004), when there is the possibility of a mixed panel, for

example, when some of the members may be stationary while others may be non-stationary, then the null and alternative hypotheses are awkwardly positioned. Specifically, for panel unit root tests the null hypothesis becomes “stationarity fails for all members of the panel” while the alternative becomes “stationarity holds for at least some members of the panel”. Nevertheless, rejection of the unit root null in the panel does not imply that stationarity holds even for the majority of the members in the panel. The most that can be inferred is that at least one of the rates is mean reverting or that stationarity holds only marginally for a few countries. In the context of fiscal sustainability, for instance, this would imply that the stock of general government debt is stationary for at least one country even though public finances may have been unsustainable for the majority of the countries in the panel sample.

However, researchers sometimes tend to draw a much stronger inference that, for instance, when in a given panel sample all government debt series are mean reverting, hence claiming to provide evidence supporting fiscal sustainability, which is not necessarily valid. Instead, for mixed panels, under most interpretations the preferred positioning of the null hypothesis would be "stationarity holds for all members of the panel" against the alternative that "stationarity fails for at least some members of the panel". This would allow testing how pervasive the fiscal sustainability condition is for any given group of countries. One way to do this would be to use a panel test for the null of stationarity (see e.g. Hadri, 2000, whose null hypothesis is stationarity). However, these tests are well known to have very poor finite sample properties, even worse than their pure time series counterparts. Another way to address this issue would instead be to directly test the restriction that the slope coefficient is equal to unity in single equation regressions between general government revenue and expenditure ratios



for each country. This would allow one to effectively reverse the null hypothesis as described above. Pedroni (2001) provides an example of this approach for the PPP condition. A third possibility would be to use a procedure allowing the researcher to identify how many and which panel members are responsible for rejecting the joint null of non-stationarity. For example, Breuer et al. (2002, 2006) advocate a procedure whereby unit root testing is conducted within a Seemingly Unrelated Regression (SUR) framework, which exploits the information in the error covariance to produce efficient estimators and potentially more powerful test statistics. A further advantage of this procedure is that the SUR framework is another useful way of addressing cross-sectional dependency. However, this SURADF test requires simulating critical values specific to each empirical environment, which is actually also generally the case for hypothesis testing with other panel tests. We will pursue this last option in this paper, in what consists of step one of our empirical methodology.

Like most panel data unit root tests that are based on the null hypothesis of joint non-stationarity (against the alternative that at least one panel member is stationary), the well-known panel cointegration tests developed by Pedroni (1999, 2004), generalized by Banerjee and Carrion-i-Silvestre (2006) are of the null of joint non-cointegration. The problem here is that a single series from the panel might be responsible for rejecting the joint null of non-stationary or non-cointegration type, hence not necessarily implying that a cointegration relationship holds for the whole set of countries. In addition, such panel tests for the null hypothesis of no cointegration have been criticized in the literature because it is usually the opposite null that is of primary interest in empirical research. This is actually also the case in the context of assessing fiscal sustainability in the EU where it would seem more natural to consider residuals-

based procedures that seek to test the null hypothesis of cointegration rather than the opposite. A possible way to overcome this difficulty is to implement the very recent bootstrap panel cointegration test proposed by Westerlund and Edgerton (2007). Unlike the panel data cointegration tests of Pedroni, here the null hypothesis is now cointegration which implies, if not rejected, the existence of a long-run relationship for all panel members (the alternative hypothesis being that there is no cointegrating relationship for at least one country of the panel). This new test relies on the popular Lagrange multiplier test of McCoskey and Kao (1998), and allows correlation to be accommodated both within and between the individual cross-sectional units. Here, we will rely on this last test for investigating fiscal sustainability in the EU. This is step two of our methodology, which will then be followed by the assessment of the magnitude of the  $\mathbf{b}$  coefficient in the cointegration regression via SUR estimation, our step three.

### 3.2. Series specific panel unit root test: SURADF

The SURADF test developed by Breuer et al. (2002, 2006) is based on the following system of ADF equations:

$$\left\{ \begin{array}{l} \Delta y_{1,t} = \mathbf{a}_1 + \mathbf{b}_1 y_{1,t-1} + \sum_{i=1}^{p_1} \mathbf{g}_{1,i} \Delta y_{1,t-i} + \mathbf{e}_{1,t} \quad t=1, \dots, T \\ \Delta y_{2,t} = \mathbf{a}_2 + \mathbf{b}_2 y_{2,t-1} + \sum_{i=1}^{p_2} \mathbf{g}_{2,i} \Delta y_{2,t-i} + \mathbf{e}_{2,t} \quad t=1, \dots, T \\ \dots \\ \Delta y_{N,t} = \mathbf{a}_N + \mathbf{b}_N y_{N,t-1} + \sum_{i=1}^{p_N} \mathbf{g}_{N,i} \Delta y_{N,t-i} + \mathbf{e}_{N,t} \quad t=1, \dots, T \end{array} \right. , \quad (6)$$

where  $\mathbf{b}_j = (\beta_j - 1)$  and  $\beta_j$  is the autoregressive coefficient for series  $j$ . This system is estimated by the SUR procedure and the null and the alternative hypotheses are tested individually as:

$$\begin{cases} H_0^1 : \mathbf{b}_1 = 0; & H_A^1 : \mathbf{b}_1 < 0 \\ H_0^2 : \mathbf{b}_2 = 0; & H_A^2 : \mathbf{b}_2 < 0 \\ \dots \\ H_0^N : \mathbf{b}_N = 0; & H_A^N : \mathbf{b}_N < 0 \end{cases} \quad (7)$$

with the test statistics computed from SUR estimates of system (6) while the critical values are generated by Monte Carlo simulations. This procedure has three advantages. Firstly, by exploiting the information from the error covariances and allowing for autoregressive process, it leads to efficient estimators over the single-equation methods. Secondly, the estimation also allows for heterogeneity in lag structure across the panel members. Thirdly, the SURADF panel integration test accounts for cross-sectional dependence among countries and allows the researcher to identify how many and which members of the panel has a unit root.

## 4. Investigating fiscal sustainability in the EU

### 4.1. Fiscal data

All data for general government expenditure and revenue are taken from the European Commission AMECO (Annual Macro-Economic Data) database.<sup>2</sup> The data cover the periods 1960-2006 for the EU15 countries, 1998-2006 for the EU25 countries, and 2000-2006 for the EU26 countries, not to consider two countries with the smallest

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<sup>2</sup> The precise AMECO codes are the following ones: for general government total expenditure (% of GDP), .1.0.319.0.UUTGE, .1.0.319.0.UUTGF; for general government total revenue (% of GDP), .1.0.319.0.URTG, .1.0.319.0.URTGF. AMECO database (updated on 04/05/2007).

number of observations in the sample.<sup>3</sup> In Table 1 we report the summary of statistics for the general government expenditure and revenue ratios of GDP for each country.

Table 1 – Statistical summary for fiscal variables (% of GDP)

1960-2006	Government revenue				Government expenditure			
Country	Mean	Max	Min	n	Mean	Max	Min	n
Austria	45.6	33.2	52.5	47	47.1	33.2	56.7	47
Belgium	43.3	27.7	51.1	47	48.0	31.7	62.1	47
Denmark	48.0	25.4	58.1	47	47.6	23.6	60.6	47
Finland	45.1	28.2	57.1	47	42.7	25.0	64.7	47
France	44.0	33.2	50.9	47	45.8	32.9	54.5	47
Germany	42.7	34.8	46.6	47	44.3	31.8	49.9	47
Greece	31.7	20.8	47.0	47	36.5	20.5	52.0	47
Ireland	34.3	22.8	43.6	47	38.5	25.8	53.2	47
Italy	36.4	26.0	47.6	47	42.7	27.1	56.3	47
Luxembourg	37.0	23.6	44.4	45	35.3	22.2	45.2	45
Netherlands	45.3	29.9	53.8	47	47.5	29.7	59.2	47
Portugal	29.4	15.8	43.5	47	32.6	14.5	47.8	47
Spain	32.8	20.9	40.1	37	35.2	20.3	46.6	37
Sweden	57.4	46.0	62.3	37	57.6	41.8	72.4	37
United Kingdom	38.5	29.8	44.1	47	40.6	32.4	45.4	47

  

1990-2006	Government revenue				Government expenditure			
Country	Mean	Max	Min	n	Mean	Max	Min	n
Bulgaria	39.7	41.1	37.4	5	38.0	38.7	37.3	5
Cyprus	37.3	44.0	32.8	9	40.9	45.9	37.1	9
Czech Republic	39.6	41.5	38.1	12	44.8	54.5	41.8	12
Estonia	38.6	46.2	34.7	14	37.1	42.4	32.3	14
Hungary	42.9	44.8	41.6	10	49.4	51.7	45.8	10
Latvia	35.3	40.1	24.0	17	35.5	41.8	24.4	17
Lithuania	34.4	38.4	31.8	12	37.2	50.3	33.2	12
Malta	38.4	44.2	32.5	9	44.7	48.6	40.8	9
Poland	41.2	46.1	38.7	12	44.6	51.0	41.1	12
Romania	38.0	42.3	36.5	9	40.8	45.7	38.1	9
Slovakia	40.1	50.9	33.1	14	47.5	77.6	36.5	14
Slovenia	45.3	46.4	44.3	7	48.0	49.1	47.2	7

Source: European Commission AMECO database.

#### 4.2. Step 1: unit root analysis

There are good reasons to believe that there is considerable heterogeneity in the countries under investigation and thus, the typical panel unit root tests employed may

<sup>3</sup> EU15 includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Ireland, Luxembourg, the Netherlands, Portugal, Spain, United Kingdom, and Sweden, EU25 excludes Bulgaria and Slovenia and EU26 excludes Bulgaria, the countries with the smaller number of observations.

lead to misleading inferences. In Tables 2 and 3 we report the results of the Im, Pesaran and Shin (2003, hereafter IPS) test, respectively for the general government revenue and expenditure ratio series for the three EU15, EU25 and EU26 panel sets. Owing to its rather simple methodology and alternative hypothesis of heterogeneity this test has been widely implemented in empirical research. This test assumes cross-sectional independence among panel units (except for common time effects), but allows for heterogeneity in the form of individual deterministic effects (constant and/or linear time trend), and heterogeneous serial correlation structure of the error terms. To facilitate comparisons, we also provide the results of two other panel unit root tests: Breitung (2000), and Hadri, (2000). Note that the tests proposed by IPS and by Breitung examine the null hypothesis of non-stationarity while the test by Hadri investigates the null of stationarity.

Concerning the general government revenue-to-GDP ratios, the results given by the panel data unit root tests are rather concomitant. Indeed, for the EU15, EU25 and EU26 panel sets, two panel data tests out of three (with the exception of the IPS test) at the ten percent level of significance, produce significant evidence in favour of their integration of order one for EU countries (see Table 2). In other words, the non-stationarity of the general government revenue-to-GDP ratios does not seem to be rejected by the data.

Table 2 – Summary of panel data unit root tests for general government revenue-to-GDP ratios

EU15 (1960-2006)			
Method	Statistic	P-value*	Cross-sections
Null: Unit root (assumes common unit root process)			
Breitung t-stat	1.85589	0.9683	15
Null: Unit root (assumes an individual unit root process)			
Im, Pesaran and Shin W-stat	-2.04906	0.0202	15
Null: No unit root (assumes a common unit root process)			
Hadri Z-stat	15.4721	0.0000	15
EU25 (1998-2006)			
Method	Statistic	P-value*	Cross-sections
Null: Unit root (assumes common unit root process)			
Breitung t-stat	3.14722	0.9992	25
Null: Unit root (assumes an individual unit root process)			
Im, Pesaran and Shin W-stat	-1.71950	0.0428	25
Null: No unit root (assumes a common unit root process)			
Hadri Z-stat	14.1348	0.0000	25
EU26 (2000-2006)			
Method	Statistic	P-value*	Cross-sections
Null: Unit root (assumes common unit root process)			
Breitung t-stat	3.10915	0.9991	26
Null: Unit root (assumes an individual unit root process)			
Im, Pesaran and Shin W-stat	-1.46087	0.0720	26
Null: No unit root (assumes a common unit root process)			
Hadri Z-stat	14.4145	0.0000	26

\* Probabilities for all tests assume asymptotic normality. Automatic selection of lags based on SIC. Newey-West bandwidth selection using a Bartlett kernel

Note: E25 excludes Bulgaria and Slovenia; E26 excludes Bulgaria.

As far as the general government expenditure-to-GDP ratios are concerned, the results are mixed and strongly depend on which one of the three EU15, EU25, and EU26 panel sets is considered. Indeed, for the EU15 panel set, the general government expenditure-to-GDP ratios appear to have a unit root for all countries at the ten per cent level of significance if one refers to the results of the Breitung and Hadri panel data unit root tests (see Table 3), whereas it is stationary according to the test by IPS. On the contrary, for EU25 and EU26 panel sets, for a more recent period, two panel data tests out of three (with the exception of the Hadri test) indicate that the null unit root hypothesis can be rejected at the five per cent level. Thus, supporting the stationarity of the general

government expenditure-to-GDP ratios and hence the mean-reverting behaviour of these series in at least one country of the EU25 and EU26 panel sets.

Table 3 – Summary of panel data unit root tests for general government expenditure-to-GDP ratios

EU15 (1960-2006)			
Method	Statistic	P-value*	Cross-sections
Null: Unit root (assumes common unit root process)			
Breitung t-stat	2.00464	0.9775	15
Null: Unit root (assumes an individual unit root process)			
Im, Pesaran and Shin W-stat	-1.95770	0.0251	15
Null: No unit root (assumes a common unit root process)			
Hadri Z-stat	13.7712	0.0000	15
EU25 (1998-2006)			
Method	Statistic	P-value*	Cross-sections
Null: Unit root (assumes common unit root process)			
Breitung t-stat	-5.09297	0.0000	25
Null: Unit root (assumes an individual unit root process)			
Im, Pesaran and Shin W-stat	-3.83025	0.0001	25
Null: No unit root (assumes a common unit root process)			
Hadri Z-stat	10.9102	0.0000	25
EU26 (2000-2006)			
Method	Statistic	P-value*	Cross-sections
Null: Unit root (assumes common unit root process)			
Breitung t-stat	-5.00878	0.0000	26
Null: Unit root (assumes an individual unit root process)			
Im, Pesaran and Shin W-stat	-3.66068	0.0001	26
Null: No unit root (assumes a common unit root process)			
Hadri Z-stat	11.1254	0.0000	26

\* Probabilities for all tests assume asymptotic normality. Automatic selection of lags based on SIC. Newey-West bandwidth selection using a Bartlett kernel  
 Note: E25 excludes Bulgaria and Slovenia; E26 excludes Bulgaria.

The rejection of the null hypothesis that all series have a unit root doesn't imply that under the alternative "all series are mean-reverting" as it is sometimes claimed by some authors in the literature since there may be a mixture of stationary and non-stationary processes in the panel under the alternative hypothesis. However, in case of the rejection of the null, the IPS and Breitung tests do not provide us with information about the exact mix of series in the panel, that is, for which series in the panel the unit

root is rejected and for which it is not. The SURADF test proposed by Breuer et al. (2002, 2006) addresses this issue. Another advantage of this procedure is that the SUR framework is a useful way of addressing cross-sectional dependency. In the context of our paper, cross-dependence can mirror possible changes in the behaviour of fiscal authorities related to the signing of the EU Treaty in Maastricht on 7 February 1992. The setting up of the fiscal convergence criteria that urged the EU countries to consolidate public finances from the mid-1990s onwards in the run-up to the EMU on 1 January 1999, when most EU legacy currencies were replaced by the euro, and more recently the adoption of the EU fiscal framework by the New Member States.

As the SURADF test has non-standard distributions, the critical values need to be obtained via simulations. In the Monte Carlo simulations, the intercepts, the coefficients on the lagged values for each series, were set equal to zero in each of the three EU15, EU25 and EU26 panel sets (see Breuer et al., 2002, 2006). In what follows, the lagged differences and the covariance matrix were obtained from the SUR estimation on the general government expenditure and revenue ratio series. The SURADF test statistic for each series was computed as the  $t$ -statistic calculated individually for the coefficient on the lagged level. To obtain the critical values, the experiments were replicated 10,000 times and the critical values of one per cent, five per cent, and ten per cent were tailored respectively to each of the fifteen, twenty-five and twenty-six panel members considered in the three panel sets.<sup>4</sup>

As is now well known, the presence of cross-section dependence renders the ordinary least squares estimator inefficient and biased, which makes it a poor candidate for

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<sup>4</sup> We are grateful to Myles Wallace for providing us the SURADF Rats codes that we adapted here for our purpose.



inference. A common approach to alleviate this problem is to use seemingly unrelated regressions techniques. However, as noted by Westerlund (2007), this approach is not feasible when the cross-sectional dimension  $N$  is of the same order of magnitude as the time series dimension  $T$ , since the covariance matrix of the regression errors then becomes rank deficient. In fact, for the SUR approach to work properly, one usually requires  $T$  being substantially larger than  $N$ , a condition that is only fulfilled for the EU15 panel over the 1960-2006 period, but not for the EU25 and EU26 panels over the 1998-2006 and 2000-2006 periods. As a consequence, for the last two panels the SURDAF test is actually performed on the (unbalanced) 1960-2006 period, according to data availability.

The results of the SURADF test are reported in Tables 4 and 5, respectively for the general government revenue and expenditure taken as a percentage of GDP. As indicated in Table 4, at the ten per cent level of significance the null hypothesis of non-stationarity of the general government revenue-to-GDP ratios cannot be rejected in any country for the EU15 panel. This hypothesis can only be rejected in one country (Poland) for the EU25 and EU26 panel sets.

Table 4 – SURADF stationarity tests with critical values for general government revenue-to-GDP ratios

4a – Country sample EU15				
	Test statistic	Critical values		
		0.01	0.05	0.10
Austria	-2.971	-5.850	-5.036	-4.596
Belgium	-3.138	-5.908	-5.103	-4.684
Denmark	-3.362	-6.022	-5.164	-4.736
Finland	-2.690	-6.314	-5.413	-4.993
France	-1.703	-6.001	-5.125	-4.688
Germany	-3.103	-5.584	-4.651	-4.207
Greece	-0.902	-6.133	-5.334	-4.903
Ireland	-3.950	-6.472	-5.575	-5.122
Italy	-1.421	-6.288	-5.383	-4.953
Luxembourg	-2.420	-6.557	-5.745	-5.337
Netherlands	-4.555	-6.594	-5.792	-5.405
Portugal	-0.838	-6.486	-5.626	-5.180
Spain	-0.759	-5.913	-5.017	-4.569
Sweden	-2.609	-6.454	-5.558	-5.113
United Kingdom	-2.728	-6.268	-5.337	-4.923

  

4b – Country sample EU25				
	Test statistic	Critical values		
		0.01	0.05	0.10
Austria	-4.135	-13.455	-11.101	-9.842
Belgium	-2.730	-13.210	-10.914	-9.759
Cyprus	-1.470	-12.320	-10.020	-8.848
Czech Republic	-1.882	-12.899	-10.880	-9.742
Denmark	-2.668	-12.973	-10.819	-9.720
Estonia	-5.937	-13.456	-11.019	-9.821
Finland	-2.488	-13.230	-10.773	-9.529
France	-2.824	-13.041	-10.743	-9.546
Germany	-5.117	-12.934	-10.485	-9.344
Greece	-0.942	-12.788	-10.600	-9.499
Hungary	-0.949	-13.502	-11.203	-10.056
Ireland	-3.976	-13.646	-11.043	-10.009
Italy	-1.402	-13.285	-10.928	-9.657
Latvia	-3.594	-15.439	-12.878	-11.653
Lithuania	-2.242	-14.575	-12.291	-11.112
Luxembourg	-4.219	-14.185	-11.871	-10.640
Malta	-0.655	-14.228	-12.012	-10.881
Netherlands	-4.309	-15.849	-13.461	-12.186
Poland	-10.989*	-14.476	-12.199	-10.974
Portugal	-1.079	-16.428	-13.971	-12.509
Romania	-8.017	-15.665	-13.378	-12.089
Slovakia	-4.785	-14.716	-12.357	-11.095
Spain	-2.714	-16.267	-13.635	-12.311
Sweden	-3.983	-16.777	-14.225	-12.769
United Kingdom	-5.653	16.598	-14.012	-12.641

4c – Country sample EU26				
	Test statistic	Critical values		
		0.01	0.05	0.10
Austria	-4.147	-14.671	-12.034	-10.744
Belgium	-2.723	-14.165	-11.779	-10.557
Cyprus	-1.461	-13.448	-11.086	-9.781
Czech Republic	-1.896	-14.740	-12.101	-10.705
Denmark	-2.665	-14.182	-11.720	-10.485
Estonia	-5.992	-14.615	-12.088	-10.786
Finland	-2.491	-14.478	-11.634	-10.327
France	-2.821	-14.242	-11.786	-10.427
Germany	-5.114	-14.237	-11.513	-10.229
Greece	-0.943	-14.155	-11.582	-10.306
Hungary	-0.944	-15.207	-12.382	-11.108
Ireland	-3.976	-14.481	-12.109	-10.752
Italy	-1.398	-14.000	-11.606	-10.393
Latvia	-3.595	-16.727	-14.078	-12.777
Lithuania	-2.255	-16.296	-13.616	-12.175
Luxembourg	-4.219	-15.486	-12.992	-11.701
Malta	-0.643	-15.694	-13.065	-11.730
Netherlands	-4.309	-17.055	-14.590	-13.092
Poland	-10.577*	-14.358	-11.250	-10.427
Portugal	-1.086	-17.947	-15.127	-13.545
Romania	-8.628	-17.282	-14.652	-13.114
Slovakia	-4.865	-16.062	-13.481	-12.137
Slovenia	-1.003	-16.732	-14.157	-12.722
Spain	-2.711	-17.677	-14.946	-13.351
Sweden	-3.980	-18.428	-15.452	-13.819
United Kingdom	-5.658	-18.226	-15.287	-13.623

\* The SURADF column refers to the estimated Augmented Dickey–Fuller statistics obtained through the SUR estimation associated to the three EU15, EU25 and EU26 ADF regressions. Each of the estimated equation excludes a time trend. The three right-hand side columns contain the estimated critical values tailored by the simulation experiments based on 10,000 replications, following the work by Breuer et al. (2002). The symbols \*, \*\*, and \*\*\* denote statistical significant at the 10%, 5% and 1% level respectively.

Note: E25 excludes Bulgaria and Slovenia; E26 excludes Bulgaria.

Moreover, according to the SURADF tests in Table 5, the general government expenditure-to-GDP ratios seem to be non-stationary in most countries, but the null of a unit root can be rejected at the ten per cent level of significance in one country (Germany) for the EU15 panel, and in four countries (Estonia, Hungary, Poland and Slovakia) for the EU25 and EU26 panel sets.

Table 5 – SURADF stationarity tests with critical values for general government expenditure-to-GDP ratios

5a – Country sample EU15				
	Test statistic	Critical values		
		0.01	0.05	0.10
Austria	-2.557	-6.384	-5.552	-5.144
Belgium	-3.002	-5.864	-5.067	-4.644
Denmark	-4.382	-6.258	-5.426	-5.009
Finland	-2.223	-5.748	-4.958	-4.517
France	-1.447	-5.308	-4.510	-4.101
Germany	-4.937*	-5.724	-5.081	-4.636
Greece	-1.933	-6.463	-5.702	-5.283
Ireland	-3.181	-6.364	-5.566	-5.143
Italy	-2.962	-6.647	-5.867	-5.475
Luxembourg	-2.226	-6.535	-5.749	-5.373
Netherlands	-4.571	-6.377	-5.539	-5.140
Portugal	-1.221	-6.482	-5.679	-5.260
Spain	-2.570	-6.712	-5.984	-5.577
Sweden	-3.471	-6.707	-6.021	-5.595
United Kingdom	-3.585	-6.485	-5.663	-5.249

  

5b – Country sample EU25				
	Test statistic	Critical values		
		0.01	0.05	0.10
Austria	-3.804	-14.112	-11.816	-10.678
Belgium	-5.154	-13.524	-11.173	-9.964
Cyprus	-4.526	-13.108	-10.631	-9.446
Czech Republic	-0.960	-13.519	-11.175	-10.102
Denmark	-2.699	-13.772	-11.215	-9.969
Estonia	-13.56***	-13.234	-10.899	-9.691
Finland	-1.439	-14.070	-11.727	-10.608
France	-3.214	-13.838	-11.495	-10.305
Germany	-7.838	-13.877	-11.503	-10.242
Greece	-2.364	-14.660	-12.193	-11.006
Hungary	-9.487*	-12.512	-10.304	-9.038
Ireland	-4.671	-15.217	-12.819	-11.519
Italy	-3.815	-15.170	-12.809	-11.486
Latvia	-0.498	-14.510	-12.220	-10.941
Lithuania	-5.022	-13.983	-11.796	-10.543
Luxembourg	-2.770	-12.853	-10.503	-9.362
Malta	-3.027	-13.367	-10.889	-9.676
Netherlands	-9.409	-15.374	-12.863	-11.599
Poland	-10.611*	-13.911	-11.412	-10.269
Portugal	-4.336	-15.011	-12.501	-11.256
Romania	-2.634	-13.359	-10.898	-9.711
Slovakia	-16.78***	-14.211	-11.659	-10.413
Spain	-5.329	-15.460	-12.986	-11.736
Sweden	-5.637	-14.832	-12.368	-11.172
United Kingdom	-1.664	-13.616	-11.480	-10.329

5c – Country sample EU26				
	Test statistic	Critical values		
		0.01	0.05	0.10
Austria	-2.663	-14.757	-12.421	-11.096
Belgium	-2.786	-13.495	-11.079	-9.907
Cyprus	-0.320	-14.257	-11.609	-10.434
Czech Republic	-3.154	-14.798	-12.174	-10.774
Denmark	-3.010	-14.850	-12.050	-10.794
Estonia	-11.258**	-12.564	-10.234	-8.858
Finland	-1.987	-13.049	-10.274	-9.090
France	-2.845	-14.693	-12.065	-10.769
Germany	-6.096	-14.673	-12.185	-10.873
Greece	-2.285	-14.837	-12.394	-11.093
Hungary	-9.661*	-13.416	-10.914	-9.605
Ireland	-2.512	-14.654	-11.951	-10.697
Italy	-2.899	-16.217	-13.523	-12.257
Latvia	-3.314	-15.135	-12.780	-11.587
Lithuania	-1.811	-16.022	-13.533	-12.318
Luxembourg	-2.989	-15.666	-13.006	-11.668
Malta	-0.869	-14.243	-11.698	-10.456
Netherlands	-3.842	-16.587	-14.116	-12.728
Poland	-9.195*	-12.564	-10.234	-8.858
Portugal	-2.875	-16.414	-13.817	-12.467
Romania	-7.018	-12.311	-9.736	-8.531
Slovakia	-11.523*	-15.260	-12.629	-11.245
Slovenia	-3.458	-12.913	-10.250	-8.973
Spain	-3.504	-16.930	-14.076	-12.773
Sweden	-4.569	-16.415	-13.924	-12.586
United Kingdom	-2.855	-8.952	-6.901	-6.034

\* The SURADF column refers to the estimated Augmented Dickey–Fuller statistics obtained through the SUR estimation associated to the three EU15, EU25 and EU26 ADF regressions. Each of the estimated equation excludes a time trend. The three right-hand side columns contain the estimated critical values tailored by the simulation experiments based on 10,000 replications, following the work by Breuer et al. (2002). The symbols \*, \*\*, and \*\*\* denote statistical significant at the 10%, 5% and 1% level respectively.

Note: E25 excludes Bulgaria and Slovenia; E26 excludes Bulgaria.

To investigate the robustness of these results, particularly for the EU25 and EU26 panel sets over the 1998-2006 and 2000-2006 periods, we carry out the recently developed bootstrap tests of Smith et al. (2004), which use a sieve sampling scheme to account for both the time series and cross-sectional dependencies of the data.<sup>5</sup> The tests that we consider are denoted  $\bar{t}$ ,  $\overline{LM}$ ,  $\overline{\max}$ , and  $\overline{\min}$ . All four tests are constructed with a unit root under the null hypothesis and heterogeneous autoregressive roots under the alternative, which indicates that a rejection should be taken as evidence in favour of

<sup>5</sup> We are grateful to Vanessa Smith for making available the Gauss codes of this test to us that we adapted here for our purpose.

stationarity for at least one country.<sup>6</sup> For the general government revenue-to-GDP ratios, the results reported in Table 6 suggest that the unit root null cannot be rejected at any conventional significance level for any of the four tests<sup>7</sup> for the three EU15, EU25 and EU26 panel sets (the last two panels excluding now Poland) over respectively the 1960-2006, 1998-2006 and 2000-2006 periods and hence provide confirmatory evidence of non-stationarity SURDAF results. For the general government expenditure-to-GDP ratios, the results of the recently developed bootstrap tests of Smith et al. (2004), reported in Table 6, confirm these findings for the three panel sets, EU15 excluding now Germany, EU25 and EU26 excluding Estonia, Hungary, Poland and Slovakia, over the 1960-2006, 1998-2006 and 2000-2006 periods respectively.

These findings permit to shed some light on the sometimes ambiguous results previously obtained in Tables 2 and 3 with the Breitung, IPS, and Hadri panel unit root tests. This is not surprising as the previous panel unit root tests rely on a joint test of the null hypothesis while the SURADF tests each member country individually using a system approach. Besides, Breuer et al. (2002, 2006) have shown that the SURADF has double to triple the power of the ADF test in rejecting a false null hypothesis.

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<sup>6</sup> The  $\hat{t}$  test can be regarded as a bootstrap version of the well-known panel unit root test of Im et al. (2003). The other tests are basically modifications of this test.

<sup>7</sup> The order of the sieve is permitted to increase with the number of time series observations at the rate  $T^{1/3}$ , while the lag length of the individual unit root test regressions are determined using the Campbell and Perron (1991) procedure. Each test regression is fitted with a constant term only. All bootstrap results reported in this section are based on 5000 replications.

Table 6 – Results of Smith et al. (2004) panel unit root test for general government revenue and expenditure-to-GDP ratios

	General government revenue		General expenditure revenue	
Test	Statistic	Bootstrap P-value*	Statistic	Bootstrap P-value*
EU15** (1960-2006)				
$\bar{t}$	-1.742	0.227	-1.774	0.221
$\overline{LM}$	3.762	0.281	3.413	0.346
$\overline{\max}$	0.518	0.997	-0.153	0.990
$\overline{\min}$	0.849	0.982	0.593	0.990
EU25*** (1998-2006)				
$\bar{t}$	-1.191	0.732	-1.568	0.257
$\overline{LM}$	4.091	0.129	3.612	0.242
$\overline{\max}$	-0.608	0.513	-1.334	0.102
$\overline{\min}$	-1.244	0.456	-2.223	0.124
EU26*** (2000-2006)				
$\bar{t}$	-1.827	0.230	-1.074	0.785
$\overline{LM}$	3.428	0.103	3.539	0.125
$\overline{\max}$	-0.537	0.754	1.019	0.995
$\overline{\min}$	1.951	0.432	2.180	0.265

Note: rejection of the null hypothesis indicates stationarity at least in one country. \* All tests are based on an intercept and 5000 bootstrap replications to compute the  $p$ -values. \*\* EU15 excluding Germany for general government expenditure-to-GDP ratios. \*\*\* EU25 and EU26 excluding Poland for general government revenue-to-GDP ratios, and excluding Estonia, Hungary, Poland and Slovakia for general government expenditure-to-GDP ratios.

It appears that we are in the case of three mixed panels, because some of the members are stationary while others are not and the SURADF test clearly enables us to identify for which members the general government revenue or/and expenditure taken as a percentage of GDP are mean reverting and for which they are not. This information obtained for each country in a panel framework taking into account the contemporaneous cross-correlation information obtained from the SUR estimates is crucial for assessing fiscal sustainability in each country of the three EU15, EU25 and EU26 panel sets. As mentioned before, this encompassing analysis has not been pursued so far in the existing empirical literature regarding the sustainability of public finances.

### 4.3. Step 2: panel cointegration

Our investigations now proceed with the two following steps. Firstly, given the results of the SURADF tests we define three new panel sets: EU14 which includes all countries of the EU15 panel except Germany; EU21 and EU22 which correspond to the EU25 and EU26 previous panel sets without Estonia, Hungary, Poland and Slovakia. Indeed, in these countries, at least one of the two series of general government revenue and expenditure is integrated of order zero, hence preventing from carrying out cointegration techniques. We then perform panel data cointegration tests of the second generation (that allows for cross-sectional dependence among countries) between government expenditure and revenue in the new defined EU14, EU21 and EU22 panel sets.

Secondly, if a cointegrating relationship exists for all countries in at least one of the EU14, EU21 and EU22 panel sets, we estimate the system

$$R_{it} = \mathbf{a}_i + \mathbf{b}_i G_{it} + u_{it}, \quad i=1, \dots, N; \quad t=1, \dots, T \quad (8)$$

by the Zellner (1962) approach to handle cross-sectional dependence among countries using the SUR estimator. This way of proceeding enables us to estimate the individual coefficients  $\beta_i$  in a panel framework and hence to investigate fiscal sustainability for each country taken individually. We finally test for homogeneity of  $\beta_i$  across country using a Wald test.



We now proceed by testing for the existence of cointegration between government expenditures and revenues, taken as a percentage of GDP, using the very recent bootstrap panel cointegration test proposed by Westerlund and Edgerton (2007). Unlike the panel data cointegration tests of Pedroni (1999, 2004), generalized by Banerjee and Carrion-i-Silvestre (2006), this test has the advantage that the joint null hypothesis is cointegration. Therefore, in case of null non-rejection we know for sure that a cointegration relationship exists for the whole set of countries of the panel set, which is crucial here to assess fiscal sustainability. On the contrary, when performing the Banerjee and Carrion-i-Silvestre (2006) methodology the problem arises that a single series from the panel might be responsible for rejecting the joint null of non-stationary or non-cointegration, hence not necessarily implying that a cointegration relationship holds for the whole set of countries. This could be less helpful when investigating fiscal sustainability since no information is provided on which panel member(s) is responsible for this rejection, that is for which fiscal sustainability does not hold.

The new test developed by Westerlund and Edgerton (2007) relies on the popular Lagrange multiplier test of McCoskey and Kao (1998), and permits correlation to be accommodated both within and between the individual cross-sectional units. In addition, this bootstrap test is based on the sieve-sampling scheme, and has the appealing advantage of significantly reducing the distortions of the asymptotic test.<sup>8</sup> The results, reported in Table 7 for a model including either a constant term or a linear trend clearly indicate the absence of a cointegrating relationship between government revenue and expenditure for the EU14 panel data set since with an asymptotic p-value

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<sup>8</sup> We are grateful to Joakim Westerlund for sending us his Gauss codes.

of 0.00 the null hypothesis of cointegration is always rejected, in line with the results of Afonso and Rault (2007a) for a shorter panel sample.

Table 7 – Panel cointegration test results between government revenue and expenditure (Westerlund and Edgerton, 2007) <sup>a</sup>

	LM-stat	Asymptotic p-value	Bootstrap p-value
<b>EU14 (1960-2006)</b>			
Model with a constant term	7.864	0.000	0.165
Model including a time trend	8.285	0.000	0.001
<b>EU21 (1998-2006)</b>			
Model with a constant term	0.703	0.241	0.631
Model including a time trend	3.998	0.000	0.576
<b>EU22 (2000-2006)</b>			
Model with a constant term	1.057	0.145	0.504
Model including a time trend	4.930	0.000	0.677

Note: the bootstrap is based on 2000 replications.

a - The null hypothesis of the tests is cointegration between government revenue and expenditure.

Note: E14 excludes Germany; E21 excludes Bulgaria, Estonia, Hungary, Poland, Slovakia, and Slovenia; E26 excludes Bulgaria; E22 excludes Bulgaria, Estonia, Hungary, Poland, and Slovakia.

An opposite and more encouraging result is, however, obtained for a model including a constant if one refers to the bootstrap critical values, indicating that for a significant level smaller than 16.5 per cent, the null hypothesis is now not rejected for the period 1960-2006. Hence at the conventional 5 and 10 per cent levels of significance, we can conclude that a cointegration relationship exists between government revenue and expenditure ratios for the EU14 panel data set. This result now differs from those reported in Afonso and Rault (2007a), who found that the hypothesis of fiscal policy sustainability was rejected for the EU15 on the period 1970-2006, and indicates that a longer time series sample may be important to assess fiscal sustainability.

Likewise, for the EU21 and EU22 panel sets, strong evidence are found in favour of the existence of a long-run relationship between government revenue and expenditure if one

refers to bootstrap critical values. This result is robust to the inclusion of a trend in addition to the constant in the estimated regression. Such a result, however, does not hold for a model including a constant and a trend if one relies on the asymptotic p-values. Interestingly, and since the two last panel sets start essentially at the end of the 1990s, this evidence regarding the existence of a long-run relationship between government revenue and expenditure is rather in line with the results from Afonso and Rault (2007a) for the EU15, for the sub-period 1992-2006 (even if for a smaller set of countries).

We then investigate whether public finances were sustainable for the model including a constant term, using a Wald statistic to test whether the panel cointegration coefficient of the general government expenditure-to-GDP ratios is equal to one or not in the cointegrating regression where revenue is the dependent variable. Over the 1960-2006 periods and for the EU14 panel data set the calculated Wald test statistic is of 6.049 with an associated p-value of 1.43%, which provides evidence in favour of the null of a common unit slope equal to one, but only at the one percent level of significance. Stronger evidence of the sustainability of public finances is obtained for the EU21 and EU22 panel data set over the 1998-2006 and 2000-2006 periods since the calculated Wald test statistics for the above hypothesis are respectively of 0.422781 and 0.005623, the associated p-values being respectively of 51.55 and 94.02%.

#### **4.4. Step 3: SUR cointegration relationships**

We now estimate the system (8) for the EU14, EU21 and EU22 panel sets to assess the magnitude of the individual  $\mathbf{b}$  coefficient in the cointegrating relationship with a SUR

approach, which is useful to address cross-sectional dependency. Those SUR estimation results are reported in Tables 8a, b and c.

Table 8a – SUR estimation for the EU14 panel (1960-2006)

Country	Coefficients <i>a, b</i> in eq. (8)		t- Statistic	Probability	Country	Coefficients <i>a, b</i> in eq. (8)		t- Statistic	Probability
Austria	<i>a</i>	9.274	11.9	0.000	Italy	<i>a</i>	6.692	4.8	0.000
	<i>b</i>	0.770	47.5	0.000		<i>b</i>	0.694	22.3	0.000
Belgium	<i>a</i>	9.410	7.2	0.000	Luxembourg	<i>a</i>	3.942	3.3	0.001
	<i>b</i>	0.706	27.4	0.000		<i>b</i>	0.936	28.3	0.000
Denmark	<i>a</i>	6.836	5.3	0.000	Netherlands	<i>a</i>	4.949	6.1	0.000
	<i>b</i>	0.865	33.5	0.000		<i>b</i>	0.849	51.6	0.000
Finland	<i>a</i>	9.553	8.1	0.000	Portugal	<i>a</i>	6.145	9.0	0.000
	<i>b</i>	0.833	32.1	0.000		<i>b</i>	0.712	38.0	0.000
France	<i>a</i>	7.798	13.3	0.000	Spain	<i>a</i>	5.264	9.8	0.000
	<i>b</i>	0.791	63.3	0.000		<i>b</i>	0.781	52.1	0.000
Greece	<i>a</i>	8.188	10.5	0.000	Sweden	<i>a</i>	23.792	16.3	0.000
	<i>b</i>	0.643	35.6	0.000		<i>b</i>	0.575	22.0	0.000
Ireland	<i>a</i>	8.164	5.0	0.000	UK	<i>a</i>	13.298	5.9	0.000
	<i>b</i>	0.677	16.9	0.000		<i>b</i>	0.620	11.3	0.000

Note: Seemingly Unrelated Regression, linear estimation after one-step weighting matrix. Balanced system, total observations: 658.

Table 8b – SUR estimation for the EU21 panel (1960-2006)

Country	Coefficients <i>a, b</i> in eq. (8)		t- Statistic	Probability	Country	Coefficients <i>a, b</i> in eq. (8)		t- Statistic	Probability
Austria	<i>a</i>	9.260	12.0	0.000	Latvia	<i>a</i>	12.149	2.9	0.000
	<i>b</i>	0.770	48.0	0.000		<i>b</i>	0.657	5.6	0.000
Belgium	<i>a</i>	9.423	7.4	0.000	Lithuania	<i>a</i>	20.856	12.8	0.000
	<i>b</i>	0.705	28.3	0.000		<i>b</i>	0.362	8.4	0.000
Cyprus	<i>a</i>	-3.815	-0.8	0.369	Luxembourg	<i>a</i>	3.747	3.3	0.001
	<i>b</i>	1.004	9.7	0.000		<i>b</i>	0.941	30.5	0.000
Czech Republic	<i>a</i>	32.744	13.3	0.000	Malta	<i>a</i>	-11.073	-1.1	0.242
	<i>b</i>	0.155	2.9	0.000		<i>b</i>	1.105	5.2	0.000
Denmark	<i>a</i>	6.893	5.4	0.000	Netherlands	<i>a</i>	5.105	6.7	0.000
	<i>b</i>	0.863	34.2	0.000		<i>b</i>	0.845	55.1	0.000
Finland	<i>a</i>	9.453	8.1	0.000	Portugal	<i>a</i>	6.103	9.0	0.000
	<i>b</i>	0.834	32.8	0.000		<i>b</i>	0.713	38.7	0.000
France	<i>a</i>	7.711	13.4	0.000	Romania	<i>a</i>	13.027	3.9	0.000
	<i>b</i>	0.792	64.9	0.000		<i>b</i>	0.611	7.5	0.000
Germany	<i>a</i>	14.360	15.5	0.000	Spain	<i>a</i>	5.273	10.1	0.000
	<i>b</i>	0.639	30.9	0.000		<i>b</i>	0.780	53.8	0.000
Greece	<i>a</i>	8.129	10.6	0.000	Sweden	<i>a</i>	23.497	16.5	0.000
	<i>b</i>	0.644	36.7	0.000		<i>b</i>	0.580	22.8	0.000
Ireland	<i>a</i>	8.283	5.4	0.000	UK	<i>a</i>	12.935	5.8	0.000
	<i>b</i>	0.674	17.9	0.000		<i>b</i>	0.628	11.6	0.000
Italy	<i>a</i>	6.499	4.7	0.000					
	<i>b</i>	0.698	23.0	0.000					

Note: Seemingly Unrelated Regression, linear estimation after one-step weighting matrix. Balanced system, total observations: 773.

Table 8c – SUR estimation for the EU22 panel (1960-2006)

Country	Coefficients <b>a, b</b> in eq. (8)		t- Statistic	Probability	Country	Coefficients <b>a, b</b> in eq. (8)		t- Statistic	Probability
Austria	<b>a</b>	9.272	12.0	0.000	Latvia	<b>a</b>	12.368	3.0	0.000
	<b>b</b>	0.770	48.0	0.000		<b>b</b>	0.651	5.7	0.000
Belgium	<b>a</b>	9.424	7.4	0.000	Lithuania	<b>a</b>	20.872	12.8	0.000
	<b>b</b>	0.705	28.4	0.000		<b>b</b>	0.362	8.4	0.000
Cyprus	<b>a</b>	-4.104	-0.9	0.331	Luxembourg	<b>a</b>	3.715	3.3	0.001
	<b>b</b>	1.011	9.8	0.000		<b>b</b>	0.942	30.6	0.000
Czech Republic	<b>a</b>	32.669	13.4	0.000	Malta	<b>a</b>	-11.842	-1.2	0.206
	<b>b</b>	0.156	2.9	0.000		<b>b</b>	1.121	5.3	0.000
Denmark	<b>a</b>	6.909	5.4	0.000	Netherlands	<b>a</b>	5.091	6.7	0.000
	<b>b</b>	0.863	34.2	0.000		<b>b</b>	0.845	55.3	0.000
Finland	<b>a</b>	9.449	8.1	0.000	Portugal	<b>a</b>	6.107	9.0	0.000
	<b>b</b>	0.835	32.8	0.000		<b>b</b>	0.713	38.7	0.000
France	<b>a</b>	7.713	13.4	0.000	Romania	<b>a</b>	13.379	4.2	0.000
	<b>b</b>	0.792	64.9	0.000		<b>b</b>	0.602	7.8	0.000
Germany	<b>a</b>	14.342	15.5	0.000	Slovenia	<b>a</b>	0.000	2.1	0.030
	<b>b</b>	0.639	31.0	0.000		<b>b</b>	1.000	8.0	0.000
Greece	<b>a</b>	8.136	10.7	0.000	Spain	<b>a</b>	5.280	10.2	0.000
	<b>b</b>	0.644	36.7	0.000		<b>b</b>	0.780	53.9	0.000
Ireland	<b>a</b>	8.286	5.4	0.000	Sweden	<b>a</b>	23.478	16.5	0.000
	<b>b</b>	0.674	17.9	0.000		<b>b</b>	0.580	22.9	0.000
Italy	<b>a</b>	6.487	4.7	0.000	UK	<b>a</b>	12.944	5.8	0.000
	<b>b</b>	0.698	23.0	0.000		<b>b</b>	0.628	11.6	0.000

Note: Seemingly Unrelated Regression, linear estimation after one-step weighting matrix. Balanced system, total observations: 780.

According to our estimation results, although the coefficient **b** is always statistically significant, and with the right sign, its magnitude is also below unity. Nevertheless, it seems fair to point out that the size of the **b** coefficient is quite high in some cases and above, for instance, 0.8, notably for Denmark, Finland, Luxembourg, and the Netherlands.<sup>9</sup> These results, which hold for all three country panels that we studied, can be read as an indicator that public finances may have been less unsustainable in the past for the abovementioned countries.

<sup>9</sup> Note that we also implemented a SUR estimation for the EU15 panel that is also including Germany. The results are only marginally modified in comparison to those for the EU14 panel, the slope coefficient for Germany being of 0.639.

On the other hand, it is also possible to observe the lower magnitude of the estimated  $\mathbf{b}$  coefficient for several countries such as Belgium, Greece, Ireland, Italy, the UK or Sweden, which reflects a bigger departure from a one-to-one linkage between expenditures and revenues in the cointegration relationship. Interestingly, and as a result of running significant budget deficits, those countries then experienced a divergent behaviour of their respective debt-to-GDP ratio during continued phases in the period 1960-2006, which would theoretically increase in infinite horizon if the magnitude of  $\mathbf{b}$  were to remain too far away and below unity. Indeed, the expenditure ratios were systematically above, and growing faster in some cases, the revenue ratios for most of the period in the cases of Belgium, Greece, Ireland, Italy and the UK while in Sweden that difference was particularly acute in the first half of the 1990s.

Regarding the new EU Members States present in the third step of our analysis, the estimated cointegration relationship shows a rather low magnitude of the  $\mathbf{b}$  coefficient for the cases of the Czech Republic and Lithuania, which can be driven by some spikes that occurred in the expenditure ratios in the period under analysis.

Finally, we also tested the homogeneity of  $\beta$  across country using a Wald test, which may in principle be useful to uncover any common behaviour for some country sub-groups. For instance, one could consider that is more likely to pair countries with less sustainable past public finances, and on the other hand lump together countries with higher estimated  $\mathbf{b}$  coefficients. The results of such tests are reported in Table 9.

Table 9 – Testing the homogeneity of  $\beta$  across countries

Panel/country group	Chi-square statistic	Probability
EU14	483.06	0.0000
EU21	1028.30	0.0000
EU22	1031.96	0.0000
Within EU21		
DK, FI, NL	0.73	0.6956
AU, FR, SP	1.84	0.3985
BE, GR, IT	14.51	0.0007
BE, IT	0.05	0.8275
GR, IT	7.13	0.0076
BE, GR	6.35	0.0118
BE, GR, IT, IR	17.71	0.0005
DE, UK	0.03	0.8518
Within EU22		
CY, MT, SL	0.65	0.7218
$b=1$ for CY, MT, SL	5.84	0.1197
$b=1$ for LU	3.47	0.0626

Note: the null is that  $b$  is the same for all countries in the sub-group.

While the homogeneity hypothesis was always rejected for the overall three EU panel sets, interestingly it held for some specific country pairings and sub-groups. For instance, it is possible to see that the null of homogeneity for  $b$ , that is the similarity in the responses of government revenues to changes in government expenditures, was not rejected jointly for Denmark, Finland and the Netherlands, and also for the cases of Austria, France and Spain. Additionally, a similar past behaviour of public finances was also not rejected for the case of Belgium and Italy, which are two countries that accumulated significant stocks of government debt during most of the period under analysis. Finally, of note is that the null of homogeneity (as well as of a unit coefficient) in the cointegration relationship is not rejected for the cases of Cyprus, Malta and Slovenia. Interestingly these are the first three countries, of the new EU Member States that replaced their legacy currencies by the euro.

## 5. Conclusion

Even if there is no single fiscal policy in the EU, panel analysis of the sustainability of public finances is certainly relevant in the context of 27 EU countries seeking to pursue sound fiscal policies within the framework of the Stability and Growth Pact. Indeed, the shared constraints on EU member countries' fiscal policy under the SGP calls for a panel approach alongside a country by country assessment. In this paper, starting from the intertemporal government budget constraint, and taking advantage of non-stationary panel data econometric techniques we assess the sustainability of public finances covering several sub-periods within the period 1960-2006 and also defining different country groupings for the 27 members of the EU.

We used a 3-step analysis where we employed (i) SURADF panel integration analysis, which seems to be the first empirical application in the context of the sustainability of public finances; (ii) panel bootstrap to test the null hypothesis of cointegration between expenditure and revenue ratios; (iii) SUR methods to assess the magnitude of the estimated coefficient of revenues in the cointegration relationship. This approach takes advantage of the increased power of panel techniques and also provides specific information regarding how far from fiscal sustainability a given country has been in the past.

According to the results of several panel unit root tests, notably with the SURADF test, general government revenue and expenditure-to-GDP ratios are not stationary for the overwhelming majority of the EU27 countries. Additionally, at the conventional 5 and 10 per cent levels of significance, we can also conclude that there exists a cointegrating relationship between government revenue and expenditure ratios for the EU14 panel data set over the period 1960-2006. A similar conclusion regarding the existence of a



cointegration relation can be drawn for the country panel sets that include the more recent members of the EU: EU21, for the period 1998-2006; and EU22, for the period 2000-2006.

Moreover, for the countries where a cointegration relation exists, we used the SUR estimator, allowing for cross-country dependence among countries, to estimate the coefficient of the expenditure ratio in a system where the revenue ratio is the independent variable. However, and even if a cointegration vector was identified for all countries, the estimated coefficient for expenditures, in the cointegration equations is usually less than one. In other words, for the period 1960-2006, government expenditures in the EU14 (in the EU21 and EU22 countries for the more recent sub-periods) exhibited a higher growth rate than public revenues, questioning the hypothesis of fiscal policy sustainability. These results suggest that fiscal policy may not have been sustainable for most countries while it may have been less unsustainable for such countries as Denmark, Finland, Luxembourg, and the Netherlands.

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