

The stance of fiscal policy

This box analyses the fulfilment of the Government's budget policy targets during the period 1997-2007. Also, the different indicators used by the Riksbank, the National Institute of Economic Research and the Ministry of Finance to measure the stance of fiscal policy are compared. With the aid of these, we arrive at an estimate for the fiscal stance in recent years and over the forecast period. Overall, fiscal policy is deemed to have been highly expansionary in 2002, contractionary in 2004, while the stance in 2003 is more difficult to judge. In 2006, it is expected to be expansionary after having been neutral in 2005. On the whole, the different budget policy targets can be considered to have been met to date. However, the accumulated effect of the stimulatory measures implemented in the central government budget in recent years, coupled with the additional steps announced in the autumn Budget Bill, means that in the absence of budget consolidation measures the surplus target is not expected to be fulfilled from 2006 and onwards.

The budget policy situation

Fiscal policy has been governed for some time now by three medium-term targets for budget policy. In 1997, the Riksdag (the Swedish parliament) decided to introduce a surplus target for the general government sector, with effect from 2000. The target was that general government net lending should be 2 per cent on average over a business cycle. The target was introduced step by step during a transition period by setting up annual surplus targets. For 1997, it was decided that the deficit in the government finances was not to exceed 3 per cent of GDP. For 1998, the aim was to achieve a balanced budget. These targets were to be attained irrespective of the economic situation. For 1999 and 2000, the targets were a surplus of 0.5 and 1.5 per cent of GDP, respectively.⁶

The principal aim of the surplus target, as it is applied and defined by the Government today, is to strengthen, via lower government debt, the public sector's position up to around 2015 ahead of the strains that will be placed on the government finances thereafter by demographic factors. A budget surplus in normal cyclical conditions also lessens the risk of incurring a substantial deficit during a protracted economic slowdown. According to one of the Maastricht criteria, a deficit in the government finances must not exceed 3 per cent of GDP.

1997 also saw the introduction of an expenditure ceiling for central government spending, with the overall objective of supporting the surplus target. The expenditure to which the target applies – called the expenditure subject to the ceiling – comprises all central government expenditure, excluding interest on the government debt, and expenditure related to the old-age pension system. The expenditure ceiling for an individual year, which normally is established three years in advance, prevents temporary rises in revenue from being used to finance increased spending. It also contributes to preventing a trend rise in government expenditure as a share of GDP and helps to ensure that consolidation measures are implemented if expenditure risks exceeding the ceiling.

To further bolster the surplus target, a balanced-budget requirement was brought in for local governments; if a local government is running a deficit one year the local government has to re-balance its finances within two years.

The adoption of budget policy targets has fostered long-term sustainability in the government finances and thereby also has boosted confidence in economic policy as a whole; the degree of discipline in fiscal policy can influence the conditions for monetary policy over and above the more direct effects that fiscal policy has on, for instance, aggregate demand and inflation.⁷ Accordingly, the Riksbank has

⁶ See *Stabiliseringspolitik i valutaunionen* (Stabilisation policy in the monetary union) (SOU 2002:16), pp. 137-138.

⁷ See the box "The significance of fiscal policy for monetary policy" in Inflation Report 2004:4 for a more detailed discussion of this aspect.

good reason to regularly monitor developments in the government finances and the fulfilment of the budget targets.

The expenditure ceiling

The expenditure subject to the ceiling has been below the ceiling every year since it was adopted in 1997 (see Table B1). Nonetheless, the Riksbank's view is that the expenditure ceiling system has not been applied fully according to the Budget Act's intentions. The difference between the expenditure subject to the ceiling and the expenditure ceiling – the budgeting margin – is supposed to be a buffer both against uncertainty in economic developments and against factors that may cause unforeseen increases in expenditure, such as increased sick leave. The budgeting margin has been very small, with the exception of 1997. That is because it has been used to increase spending. The expenditure ceiling has also been circumvented by giving new benefits in the form of tax reductions, e.g. a tax reduction for companies supplying their staff with a PC (SEK 2.4 billion), reduced social security contributions for small companies (SEK 1.2 billion), increased central government support to the local government sector by crediting the local government's tax accounts (SEK 9 billion) and employment subsidies to companies that hire long-term unemployed (SEK 3.8 billion).⁸ These procedures risk undermining the purpose of the expenditure ceiling.

The Riksbank's assessment is that the expenditure ceiling will be met in the next

couple of years as well, although the budgeting margin is expected to remain small.

Discretionary fiscal policy during the forecast period

The Government has announced measures that will weaken the government finances by SEK 27 billion in 2006 and SEK 5 billion in 2007. The Riksbank's forecast is based on an assumption that the Government in 2007, in addition to the already announced measures, will implement further steps that increase expenditure subject to the ceiling and reduce revenue. This forecast is justified by the experiences of recent years, where expenditure subject to the ceiling has turned out considerably higher than originally planned the closer one gets to the budget year in question, and where the expenditure ceiling, as noted above, also has been sidestepped through new benefits in the form of tax reductions. At the same time, it should be stressed that the estimate for discretionary fiscal policy for the forecast years is highly uncertain.

Net lending of general government and sub-sectors

Table B2 shows developments in net lending since 1997 and the Riksbank's forecasts for the years 2005-2008. With the exception of isolated years, the surplus in the government finances has mainly arisen in the old-age pension system and is expected to do so during the forecast period as well. From 2004 onwards, local government net lending is forecast to show a small surplus owing to previous local government tax hikes,

Table B1. Central government expenditure ceiling. SEK billion

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Expenditure ceiling	723	720	753	765	791	812	822	858	870	907	949
Expenditure subject to ceiling	698	718	751	760	786	812	819	855	869	905	942
Budgeting margin	25	2	2	5	5	0	3	3	1	2	7

Sources: NIER and the Riksbank.

⁸ See "Redovising av skatteutgifter" (Account of tax expenditure), appendix 2 to the 2005 Spring Fiscal Policy Bill (prop. 2004/05:100). The figures are for 2005 and in some cases are accumulated amounts.

Table B2. Net lending of general government and sub-sectors and accumulated budget balance in the local government sector.
Per cent of GDP and SEK billion

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total	-1.0	1.9	2.3	5.0	2.6	-0.5	-0.2	1.5	1.6	1.1	0.7	1.2
Central government	-1.1	0.5	4.2	2.6	7.4	-1.8	-1.8	-0.6	-0.8	-1.1	-1.4	-1.1
Old-age pensionsystem	0.5	1.3	-2.0	2.2	-4.6	1.9	1.9	1.9	2.0	2.0	2.0	2.0
Local governmentsector	-0.5	0.2	0.1	0.2	-0.2	-0.5	-0.2	0.2	0.4	0.2	0.1	0.3
Accumulated budget balance in local government sector						-7	-8	-6	5	7	4	9

Sources: Statistics Sweden and the Riksbank.

restraint in spending, higher central government grants and a pick-up in resource utilisation that contributes to higher revenue. The balanced-budget requirement for local governments has been achieved with a lag but is judged to be met throughout the forecast period.

Central government net lending has been negative since 2002 and is expected to remain so throughout the forecast period. The stimulatory measures announced in the Budget Bill for 2006 and the Riksbank's assumption regarding additional measures in 2007 support this view. However, a large uncertainty factor as regards developments in central government net lending in the coming years is the impact of the new rule requiring companies to pay a standard rate of interest on funds moved to their tax allocation reserves. On account of this new rule, companies in 2004 decided to reverse a relatively large share of these tax allocation reserves for taxation, which increased corporate tax revenue. It is now less profitable to allocate funds to the reserves which, all other things being equal, points to higher corporate tax revenue this year and in the next few years as well even if no reversals are made. At the same time, many companies have brought forward reversals that would have been done in the coming years instead if no rule change had been made. The size of the reversals and the corporate tax revenue in the period ahead also depends on companies' financial position and interest rate developments. It is difficult to estimate the net effect of all these different factors on net lending.

As regards the distribution of net lending

between the different sub-sectors it should be noted that the increase in local government net lending to some extent, via higher central government grants, has come at the price of lower central government net lending. In 2001, the distribution of general government net lending was also affected by large transfers between the old-age pension system and the central government, due to the change in the pension system.

The surplus target and estimates of the cyclically adjusted budget balance

During the period 1997-2000, the annually established surplus targets were exceeded by a good margin (see Table B2). The strong improvement in the government finances in the years 1997 - 1998 was a result of the introduction of the surplus target, the more austere budget process, the programme of consolidation (carried out between 1994 and 1998) and surprisingly high growth. In 1998, a marked rise in employment also contributed to the improvement in the government finances. Furthermore, in 1999, but even more so in 2000, unexpected and temporarily very high tax receipts from corporate profits and capital gains added to the large surpluses in the government finances.

Since 1998, the central government budget has been highly expansionary almost every year. The reforms concerning the central government budget during the period 1998-2006 total just over SEK 200 billion.⁹ However, central government net lending, expressed as

⁹ See the box "Expenditure cuts and reforms" in *The Swedish Economy*, March 2003, NIER, and Budgetpropositionen för 2006 (The Budget Bill for 2006), Ministry of Finance.

a share of GDP, has decreased relatively little in relation to the overall size of these reforms. One explanation for that may be the introduction of the new budget process, which even in the absence of regulatory changes can improve the underlying balance since nominal expenditure is not automatically adjusted for inflation in the same way as before. Another possible explanation is that revenue has been relatively high for several years, partly due to temporary factors (see also below).

The surplus target, as it is defined from 2000, can be evaluated by calculating the general government sector's annual net lending for a whole business cycle. If net lending is 2 per cent on average, the surplus target has been met. During the period 2000 - 2004, net lending averaged 1.7 per cent. Since the period does not cover an entire business cycle it is difficult to determine whether this surplus has been consistent with the target. Resource utilisation is judged by many to have been relatively low for the greater part of this period, though, suggesting that average net lending of 1.7 per cent has been consistent with the target. However, when assessing the fulfilment of the surplus target and whether the central government will run an underlying deficit in the period ahead it should be remembered that the temporarily high tax receipts around the years 2000 and 2004 as well as low interest expenditure on the government debt have helped to push up average net lending during this period.

Estimates of underlying surpluses or deficits in the government finances are usually made using calculations of the cyclically adjusted budget balance. This is commonly defined as the financial position of the general government in the event of normal resource utilisation, given no changes in tax and spending rules. It shows, in other words, the difference between the general government sector's revenue and expenditure when the business cycle is midway between a boom and a recession. The cyclically adjusted balance is derived by subtracting from actual

net lending the component that is judged to be attributable to cyclical factors (the cyclical balance). An annual cyclically adjusted balance of around 2 per cent indicates that the surplus target has been fulfilled. One advantage of this measure is that it enables surplus target fulfilment to be forecast without the forecast period covering a whole business cycle. At the same time, calculations of the cyclically adjusted balance are highly uncertain because it is difficult to estimate both resource utilisation and the cyclical sensitivity of the government finances. Estimates of the cyclically adjusted balance should therefore be interpreted with great caution.

Table B3 shows how the cyclically adjusted balance has developed between 2004 and 2007, according to the method used by the Riksbank in its analyses for the European Central Bank (referred to here as the ESCB method).¹⁰ A comparison is also made with the Government's estimate.

The Government calculates cyclically adjusted net lending on the basis of an estimated output gap and an "aggregated" budget elasticity that is assumed to be 0.7. That means that if the (estimated) output gap changes by 1 percentage point, the cyclical component of net lending as a share of GDP is judged to change by 0.7 percentage points. An example may illustrate how the cyclically adjusted balance is estimated using this method. Assume that net lending amounts to 3.4 per cent of GDP during an economic boom and that the output gap is estimated to be 2 per cent of GDP. The cyclical component of net lending will then amount to 1.4 per cent of GDP ($0.7 \times 2 = 1.4$). The estimate of the cyclically adjusted balance therefore becomes 2 per cent ($3.4 - 1.4 = 2.0$).

The ESCB method instead decomposes a number of tax and expenditure bases into a trend and a cyclical part (using a HP filter). The cyclical component of each tax and expenditure base is obtained by multiplying the "gap" that the decomposition results in by an estimated

¹⁰ ESCB stands for European System of Central Banks.

elasticity that shows how the tax or expenditure varies with each "gap". For instance, if actual private consumption, which is the principal base for indirect taxes (e.g. VAT), is above the estimated trend value in a particular year, this is interpreted to mean that the revenue from indirect taxes in this year is higher than "normal", i.e. that there is a positive "cyclical component" in the indirect taxes. Consequently, this method does not estimate the cyclically adjusted balance on the basis of an assessment of the aggregate output gap. One advantage of this method compared with the "aggregated" method based on an estimated output gap is that it, at least in some measure, takes account of "composition effects"; i.e. that different kinds of macroeconomic shocks can affect the tax and expenditure bases in different ways. The benefit of the "aggregated" method, on the other hand, is that it is somewhat more transparent and the results are directly based on a total measure of economic conditions.¹¹

Both the ESCB method and the Government's estimate indicate that the surplus target was fulfilled in 2004 and that it also will be fulfilled in 2005. Unexpectedly high corporate tax revenue, surprisingly moderate public sector consumption and lower-than-expected interest expenditure on the government debt have contributed to a considerably higher cyclically adjusted balance for these years compared with the forecasts presented by the Riksbank in a box in Inflation Report 2004:4. At the same time, there is some uncertainty over whether the improvement in the government finances, in relation to previous estimates, is due to inaccurate forecasts of the underlying budget balance or whether the improvement can largely be explained by temporary factors. Provided that the current fiscal stance remains unchanged, i.e. that no decisions are made regarding cutbacks, the surplus target is not expected to be attained

during the coming two years. The expansionary reforms announced in the autumn Budget Bill, coupled with previous measures that also have weakened the central government budget balance, contribute to this.

Table B3. The cyclically adjusted budget balance. Per cent of GDP

	2004	2005	2006	2007
ESCB method	2.1	2.3	1.3	0.5
Government's estimate	2.1	2.1	1.0	1.1

Sources: Ministry of Finance and the Riksbank.

As noted above, the Riksbank's forecast is based on an assumption that the Government will take further budget-weakening steps for 2007, in addition to those already announced. Even without that assumption it is not anticipated to be possible to fulfil the surplus target in the period ahead, as also indicated by the Government's own estimates. In the Budget Bill for 2006, the Government explains that it expects to fall short of the surplus target largely because of discretionary stabilisation policy that has been warranted by the weak growth in the labour market.¹² However, a closer study of the discretionary fiscal policy in the Government's budget shows that the deterioration in the central government finances is not due to temporary stabilisation policy only but also to more permanent balance-weakening reforms on the revenue and expenditure sides; e.g. the income tax cut for households (as compensation for employees' contributions to the new pension system) that has been implemented in several steps in recent years, the reforms in healthcare, the school system and care services, and the higher ceilings in the national health insurance and parental insurance schemes.¹³ The Government's own forecasts for the cyclically adjusted budget balance show that the surplus target is not achieved even when resource utilisation is judged to be normalised in 2007 and 2008 and when the target for open

¹¹ See Boije, R. (2004), "The general government structural budget balance", *Sveriges Riksbank Economic Review* 1, for a more detailed description of these methods.

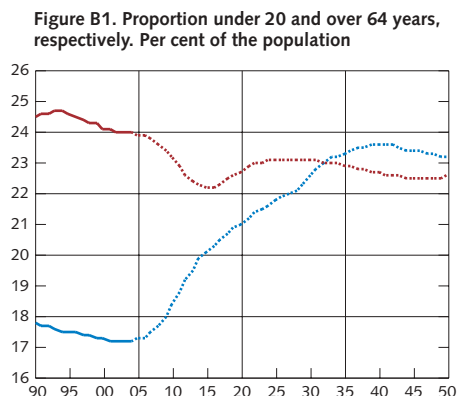
¹² See Prop. 2005/06:1, *Budgetpropositionen för 2006* (the Budget Bill for 2006), Ministry of Finance.

¹³ At the same time, from a stabilisation policy perspective it may be justified to implement permanent reforms at a time that helps to improve economic conditions provided that it does not jeopardise the budget policy targets.

— Under 20
— Over 64

Note. The broken lines represent Statistics Sweden's forecasts.

Source: Statistics Sweden.



unemployment has been met (re-defined in terms of the new EU-harmonised Labour Force Survey data); and even then the Government has assumed, for the end of the forecast period, that the budgeting margin below the expenditure ceiling will be considerably wider than has been the outcome in recent years, i.e. it is assumed that the budgeting margin will not be used for new expenditure reforms, unlike in previous years. This leads to the conclusion that discretionary budget consolidation measures are likely to be required if the surplus target is to be met in the period ahead.

To sum up, this discussion shows that the Government's budget policy targets on the whole have been achieved to date even though local governments have fulfilled the balanced-budget requirement with a lag and the expenditure ceiling has not been applied fully according to the Budget Act. The estimates for the cyclically adjusted balance in 2004 and 2005 have been revised up because the government finances have developed more favourably than previous forecasts. However, there are signs that this upswing may be temporary to some extent. Forecasts for the cyclically adjusted balance indicate that, in the absence of discretionary consolidation measures, it may prove difficult to attain the surplus target from 2006 onwards (allowing for the uncertainty that exists in this measure). Central government net lending, in particular, is too low. That is because the central

government budget has been expansionary since 1998 which, in accumulated terms, is deemed to have contributed to an underlying (structural) deficit in the central government finances. These tendencies are worrying, not least given that the demographic situation has been relatively favourable for the government finances in recent years but will no longer be so from 2008 onwards (see Figure B1).¹⁴ The less-than-strict application of the budget policy targets also risks contributing to a gradual erosion of their purpose. In the long run, this could make it more difficult to manage the future strain on the government finances resulting from demographic developments.

Fiscal policy indicators

The Riksbank, the National Institute of Economic Research (NIER), the Ministry of Finance and international institutions such as the European Commission, the OECD, the IMF and the ECB use various fiscal policy indicators both to measure whether the government finances are sustainable over the medium term (usually a business cycle) and to get an idea of the fiscal stance. The term 'stance' usually means whether discretionary fiscal policy decisions that affect public sector expenditure and revenue have a contractionary or expansionary effect on the economy. Such indicators are sometimes also used together with changes in the official interest rate to analyse the policy mix, i.e. the overall stance of fiscal and monetary policy.¹⁵

Common to the indicators usually used to measure the fiscal stance is that they first and foremost seek to measure the impact on net lending of discretionary decisions. It should be noted, however, that even in the absence of discretionary decisions fiscal policy has an indirect effect on the economy and net lending through automatic stabilisers. In Sweden, consumption and income are taxed relatively highly, and transfers are largely based on the

¹⁴ The share of the population over 64 years will begin to rise in 2008. The negative effect of this on the government finances will be slightly lessened, however, by the fact that the proportion of the population under 20 years is projected to decrease until around 2015. After 2015, though, both of these shares are forecast to increase over a long period.

¹⁵ For instance, the European Commission and the NIER perform such analyses. See *Public Finances in EMU – 2005* and *The Swedish Economy*, August 2005.

principle of loss of income, e.g. unemployment benefit. The tax and benefit system thus contributes automatically to bolstering demand during economic declines, while the opposite applies during booms. Automatic stabilisers can have a considerable impact on net lending and the economy, often much larger than the effect of discretionary decisions. The change in net lending due to both discretionary decisions and automatic stabilisers can be seen as the total fiscal policy effect or impulse on the economy.

This section aims to describe the fiscal stance indicators used by the Riksbank, the NIER and the Ministry of Finance, how they differ, their respective advantages and drawbacks, and what this means for the interpretation of the indicators' results. The different indicators are then also used to arrive at an overall assessment of the stance of fiscal policy during the period 2002 - 2007.

It should be pointed out that it is not possible on the basis of simple indicators to say how fiscal policy (or monetary policy) affects the economy more precisely. For that end, considerably more complex analysis tools are required. That is because a given change in general government net lending (or the repo rate) can have different effects on the economy depending on what other changes have occurred during the same period.

The indicators used by the Riksbank, the NIER and the Ministry of Finance

The various indicators usually used to gauge the discretionary stance of fiscal policy and its impact on net lending can essentially be divided into three different categories.

(i) One method is to calculate – on the basis of current rules for tax, benefits and other expenditure – the effects on net lending of changes in tax rates, benefit levels or public consumption. As regards changes in the tax

rates, for instance, these are multiplied by the relevant tax bases. The calculation is performed statically, i.e. it is assumed that the bases are not affected by the changed taxes (or the changed expenditure). When the effects on net lending of all the rule changes are totalled and related to GDP, this gives a measure of the fiscal stance. The Ministry of Finance uses this method to calculate the size of the central government's discretionary fiscal policy in the Budget Bill.¹⁶ Thus, the indicator does not include the other components of the public sector. However, the Ministry of Finance uses a different indicator for that (see below).

(ii) The impact on net lending due to changes in policy also can be estimated with more mechanical methods. The NIER assumes that direct and indirect taxes as well as social security contributions, given unchanged rules, are proportional to the respective tax and contribution base. If the tax or contribution shares are changed from one year to the next it is interpreted to be the result of discretionary fiscal policy measures. For other revenue, the norm used is that these, given unchanged policy, constitute over time a constant share of the nominal potential gross domestic product. A change in the share between two years is interpreted as the result of discretionary measures. As regards expenditure, it is assumed that unemployment benefit, given unchanged rules, is proportional to the number of unemployed. For public consumption and other expenditure, the norm applied is that these, given unchanged policy, constitute a constant share of the nominal potential gross domestic product. If the expenditure shares change between two years it is interpreted as the result of discretionary measures. When the deviations from the norm share for each revenue and expenditure category are totalled, this gives what the NIER calls the *policy-dependent change in net lending*.^{17, 18}

¹⁶ See Prop. 2005/06:1, *The Budget Bill for 2006*, Ministry of Finance, Sweden's Economy, appendix 2.

¹⁷ The indicator is based on a method proposed by Braconier, H. & Holden, S., "The Public Budget Balance – Fiscal Indicators and Cyclical Sensitivity in the Nordic Countries", WP 67, NIER. On the basis of this indicator, a new method for calculating the cyclically adjusted budget balance has also been developed. See Braconier, H. & Forsfält, T., (2004), "A New Method for Constructing a Cyclically Adjusted Budget Balance: The Case of Sweden", WP 90, NIER.

¹⁸ The Swedish National Financial Management Authority uses a similar method for the central government budget balance. See Braconier, H., Andreasson, P. & Jönsson, H. (2001), "Budgetpolitisk indikator" (Budget policy indicator), *Budgetprognos 2001:3*.

A simplified example shows how the NIER's indicator should be interpreted. The principal tax base for indirect taxes is composed of total private consumption. Let us assume that indirect taxes expressed as a share of total private consumption (the implicit tax ratio) is 20 per cent initially. If private consumption totals SEK 1,200 billion, indirect taxes in this example will be SEK 240 billion. If private consumption increases by SEK 10 billion and indirect taxes at the same time rise by SEK 2 billion, this is interpreted, with the NIER's indicator, to mean that discretionary fiscal policy (concerning indirect taxes) is unchanged. However, if taxes increase by more or less than SEK 2 billion (in which case the implicit tax ratio has changed), it is interpreted as a result of discretionary political decisions.

(iii) The stance of fiscal policy can also be measured by the change in the primary cyclically adjusted balance. Primary here means that the effect of changes in interest expenditure and interest income has been excluded.¹⁹ A decrease in the primary cyclically adjusted balance between two points in time is interpreted to mean that discretionary fiscal policy is expansionary while an increase is taken to signify contractionary policy. Both the Ministry of Finance and the Riksbank use the change in the (primary) cyclically adjusted balance as an indicator of the fiscal stance (including the local government sector and the old-age pension system).

Advantages and drawbacks of the different indicators

Method (i) is likely the one that gives the best precision as regards the impact on net lending due to discretionary measures since it is based on actual changes in tax rates and "benefit rates" and the relevant tax and expenditure bases. As noted above, the Ministry of Finance only makes such detailed calculations for the policy changes that concern the central

government budget. It would be simple to also include the local government sector in the calculation as regards changes in local government tax rates. On the other hand, it is difficult to estimate discretionary changes in local government consumption (as described above, the NIER estimates such changes by assuming that local government consumption, in the absence of new decisions, constitutes a constant share of the nominal potential gross domestic product). Another complicating factor is the central government grants received by local governments. These grants can be used to boost local government consumption, in which case they are likely to contribute to higher total demand in the economy. To the extent that they instead are used to consolidate local government budgets, they only result in a re-allocation of total general government net lending.

The advantage of using the NIER's mechanical method or the change in the primary cyclically adjusted balance is that these indicators cover the whole public sector and not just the central government budget. Furthermore, the NIER's method also captures "composition effects". One problem with the NIER's indicator, however, is that the tax and expenditure shares can change for other reasons than rule adjustments, e.g. demographic or behavioural changes. For example, if consumers increase their consumption of goods with a higher VAT rate, it will be interpreted as a result of a discretionary tax hike. Moreover, household income tax is progressive and not proportional, as the norm presupposes.

A big problem with using the change in the primary cyclically adjusted balance as an indicator of the fiscal stance is that it often captures economic changes that affect actual net lending but that are not a result of discretionary fiscal policy. This happens, for instance, in the event of large demographic changes, behavioural changes or when the methods used to estimate the cyclically adjusted balance do not take account of the fact that the government finances are

¹⁹ If this effect is not excluded, a change in the cyclically adjusted balance caused by a change in the net interest amount may be incorrectly interpreted as discretionary policy.

influenced to different degrees by different kinds of economic shocks. For a country like Sweden, which taxes assets to a large extent, sharp variations in asset prices could have a relatively big impact on net lending. If this is not factored in when estimating the cyclically adjusted balance, a change in this could be incorrectly interpreted as the result of discretionary fiscal policy measures. It is also one likely explanation for why many measures of the cyclically adjusted balance covary with actual net lending.²⁰

If the aim is to use the change in the primary cyclically adjusted balance as an indicator of the impact on net lending due to all discretionary decisions, including normally occurring stabilisation policy measures (e.g. labour market policy measures), it is important that the estimated cyclical component of net lending only captures the effect of automatic stabilisers. In practice it is often difficult to take this problem into account, which means that the change in the cyclically adjusted balance (at best) can be interpreted as the effect of discretionary decisions excluding stabilisation policy measures.^{21, 22}

The various indicators have their respective merits and weaknesses. Since the indicators have to be estimated and thus cannot be compared with historical outcomes, it is not possible to use statistical methods to determine which indicator has the best precision. That suggests that there is reason to employ several different methods.

How has the fiscal policy stance varied over time according to these indicators?

Table B4 shows the picture that the Riksbank, the NIER and the Ministry of Finance give of the fiscal stance from 2002-2007, as estimated using the indicators described above. All indicators factor in the effects of the proposals in the autumn Budget Bill. As noted previously, however, the Riksbank's forecast, unlike those of the NIER and Ministry of Finance, is based on an assumption that the Government will take further budget-weakening steps for 2007, in addition to those already announced. This, different views of economic conditions back in time and differences in macro forecasts mean that the results from the indicators cannot be compared straight off.²³

Table B4. Indicators of the fiscal policy stance 2002-2007.
Change in per cent of GDP

	2002	2003	2004	2005	2006	2007
National Institute of Economic Research						
Policy-dependent change in net lending	-1.9	0.0	1.0	0.0	-0.7	0.2
Ministry of Finance						
Discretionary fiscal policy in the central government budget	-1.8	-0.5	-0.4	-1.3	-1.0	-0.2
Change in primary structural balance	-2.4	-0.3	0.7	-0.2	-1.0	0.3
ESCB						
Change in primary structural balance	-2.1	0.7	1.3	0.1	-1.1	-0.8

Note. ESCB only excludes interest expenditure on the central government debt, not interest income on debt securities. The NIER excludes interest income as well. The Ministry of Finance excludes net capital income, including dividends from state-owned companies and the Riksbank.

Sources: Ministry of Finance, NIER and the Riksbank.

20 Another explanation is that the methods usually used to estimate the cyclically adjusted budget balance do not consider the fact that fiscal policy in itself influences resource utilisation. This specific problem can be solved by estimating the cyclically adjusted balance with the aid of a structural VAR model (SVAR). See, for example, Bouthevillain, C & Quinet, A., (1999), "The Relevance of Cyclically Adjusted Public Balance Indicators – the French Case, in *Indicators of Structural Budget Balances*, Banca d'Italia.

21 In principle, this problem could be managed by simulating the effect of automatic stabilisers in a general equilibrium model (with a comprehensive description of public sector revenue and expenditure) while holding discretionary policy unchanged. For example, the European Commission has performed such simulations in its QUEST model. See *Public Finances in EMU – 2001*, which also contains references to other studies.

22 If, on the other hand, the aim is to use the level of the cyclically adjusted balance as an indicator of net lending under normal resource utilisation or the change in it as an indicator of how "permanent" reforms affect the underlying balance, it is not a problem if the cyclical balance includes discretionary stabilisation policy measures.

All indicators show that fiscal policy was expansionary in 2002: net lending decreased by roughly 2 per cent of GDP due to the expansionary policy. Reforms in the central government budget, e.g. reductions in income tax on work and measures in healthcare, the school system and care services explain the bulk of the expansionary policy that year.

For 2003, both Ministry of Finance indicators point to somewhat expansionary fiscal policy. The NIER's indicator shows a neutral policy whereas the ESCB's method indicates fiscal tightening. So, for that year the indicators provide slightly different pictures of the fiscal stance. It is difficult to determine the reasons for this without a more in-depth comparison of the indicators.

For 2004, the NIER's indicator and the change in the primary cyclically adjusted balance according to both the Ministry of Finance's and the ESCB's method point to relatively tight fiscal policy in spite of stimulatory measures in the central government budget. That indicates that 2004 had relatively large contractionary discretionary measures that are not evident in the effects of the announced steps in the central government budget. What factors can explain this difference?

The Ministry of Finance's two indicators differ by just over 1 percentage point for 2004. According to the Ministry, some three-tenths of the difference is explained by higher net lending in the local government sector (mainly due to local government tax hikes) and fourth-tenths by increased corporate tax revenue partly owing to interest on tax allocation reserves. Actual public expenditure in 2004 was much lower than implied by the norms applied by the NIER when calculating expenditure for an unchanged policy. In addition, corporate tax revenue was higher than the NIER's norm for an unchanged policy. These deviations are thus interpreted as the result of contractionary fiscal policy. So these factors explain why the indicators that cover the

entire public sector reflect contractionary fiscal policy in 2004 in spite of expansionary measures in the central government budget.

Despite a considerably expansionary fiscal stance in the central government budget, the other indicators on the whole point to neutral discretionary fiscal policy for 2005. For this year, too, improved local government saving and/or higher corporate tax revenue may explain a large part of the difference between these indicators and the aggregate effect of the rule changes concerning the central government budget.

All indicators show that fiscal policy will be expansionary in 2006, which is consistent with the additional measures announced by the Government for that year.

For 2007, the Riksbank predicts, as noted above, that fiscal policy will be more expansionary than indicated by the measures announced by the Government to date. That means that the cyclically adjusted balance is projected to decrease in 2007. In the absence of budget-weakening steps over and above those already announced by the Government, fiscal policy in the same year is instead forecast to be neutral or slightly contractionary.

Revisions of the indicators over time

Even though the precision of the different indicators cannot be tested, it might be interesting to see how the estimates of the indicators for a certain year have changed over time. Table B5 shows how the outlook on the fiscal stance for 2004 has been revised between different forecasting occasions. To improve the comparability of the indicators, the compared forecasts are those that have been presented in or in conjunction with the Budget Bill (BB) and that have factored in the reforms announced in the Bill.

Both Ministry of Finance indicators showed, at the time the forecasts were prepared in autumn 2002, that fiscal policy would be

23 At the same time, it should be pointed out that different estimates of resource utilisation do not necessarily affect the forecast for the cyclically adjusted balance since these differences also influence the forecast for actual net lending.

**Table B5. Indicators of the fiscal policy stance in 2004, revisions over time.
Change in per cent of GDP**

National Institute of Economic Research		ESCB		Ministry of Finance		
Policy-dependent change in net lending		Change in primary structural balance		Discretionary measures in the central government budget		Change in primary structural balance
	2004		2004		2004	2004
December 2002	0.5	November 2002	0.3	BB for 2003	-0.3	-0.2
December 2003	0.5	November 2003	0.2	BB for 2004	-0.2	0.1
December 2004	0.8	November 2004	0.9	BB for 2005	-0.4	0.1
October 2005	1.0	November 2005	1.3	BB for 2006	-0.4	0.7

Sources: Ministry of Finance, NIER and the Riksbank.

expansionary in 2004, whereas the two other indicators at the time indicated that fiscal policy would instead be contractionary. Between 2002 and 2005 the forecast of fiscal policy austerity for 2004 has been revised up by 0.5-1.0 per cent of GDP, as measured by the indicators that cover the whole public sector. At the same time, the results show that this revision for 2004 cannot be due to the central government budget having become more contractionary over time owing to additional consolidation measures for that year. Instead, the discretionary fiscal policy in the central government budget for that year has become somewhat more expansionary over time, according to the indicator that measures the effect of rule changes in the central government budget. Lower public (mainly local government) consumption, higher local government taxes and larger-than-expected corporate tax revenue may explain a large part of the revision.²⁴

To sum up, this discussion shows that it is important when analysing the stance of fiscal policy to not only take account of the direct effects of rule changes announced in the central government budget. Also, there is considerable uncertainty in the estimate of the fiscal stance for an individual year, both between different indicators and over time. That means that the prospects for conducting a forward-looking, fine-tuning stabilisation policy are not especially good. It also implies that it is important when evaluating the policy mix and the monetary policy decisions in, for example, autumn 2002, to use the estimates of the fiscal stance that were available then and that in retrospect have probably proved to be incorrect. Overall, fiscal policy turned out, at least according to the indicators presented here, much more contractionary in 2004 than predicted by the Riksbank, the NIER and the Ministry of Finance at the end of 2002.

²⁴ At the end of 2003, Statistics Sweden began to report tax revenue fully in accrual-based terms in the National Accounts, which in itself affects the distribution of tax revenue between years. The forecast of the accrual effects has been revised several times, making it difficult to analyse the cause of the changes in forecasts for a certain year over time.