Fiscal policy – 1990s, now and in the future

This box contains a discussion of the significance of the change in fiscal policy framework during the 1990s for economic policy, whether the budget policy objectives have been achieved so far and whether they are expected to be achieved in coming years.[8] In conclusion, there is also a discussion of the role of fiscal policy in the light of the challenges facing the welfare system.

The change in fiscal policy framework

Following the deep crisis at the beginning of the 1990s, Sweden changed its exchange rate system and essentially altered both monetary policy and fiscal policy. The Riksbank was given responsibility for monetary policy with the objective of price stability. The debate conducted prior to the referendum on the euro brought to the fore the significance of the Riksbank and monetary policy for economic policy. However, the change in fiscal policy has probably had equal significance for the stable macroeconomic development since the crisis years in the beginning of the 1990s.

Fiscal policy was primarily aimed at improving public finances during the period 1994-1998. Its main aim was to reduce the large central government debt. The consolidation programme, which was originally presented in autumn 1994, contained a strengthening of public finances of around SEK 125 billion. This programme was implemented in stages during 1995 and 1998. During the same period, the budget process was tightened. One important change was that the Riksdag (the Swedish parliament) first makes a decision on the total expenditure level and thereafter decides on allocation of this to the various expenditure areas. The different ministries are then given the task of producing concrete proposals as to how reforms entailing either increased expenditure or reduced tax revenue should be financed. Automatic increases following on from growth in volume or prices are no longer permitted in contributions to local governments or in other expenditure.

In addition, fiscal policy was given two overriding budget policy targets which can also be regarded as restrictions to the budget process. Central government expenditure is not allowed to exceed the ceiling set by the Riksdag and the net lending of the general government sector – that is to say, the difference between revenue and expenditure – shall show a surplus of 2 per cent on average over a business cycle.

The expenditure ceiling has two central purposes. One is to prevent temporary increases in tax revenue being used for permanent increases in expenditure. The other is to guarantee that savings measures will be taken if the expenditures risk exceeding the ceiling.[9] The expenditure ceiling for an individual budget year is established by the Riksdag in a rolling schedule three years in advance.

The purpose of the surplus target is to both reduce public sector debt as a percentage of GDP and create financial scope to guarantee the implementation of stabilisation policy measures and allowing automatic stabilisers to act without exceeding a public finances deficit of 3 per cent of GDP in adverse economic circumstances (the latter being one of the Maastricht convergence criteria).[10]

There are at least two reasons why it is desirable to reduce public sector debt from the present level. One is that, in the absence of other reforms, it will otherwise be difficult to manage the increased expenditure caused by the growing percentage of elderly people in the population. The other is that one of the Maastricht criteria requires that the consolidated gross debt should not exceed 60 per cent of GDP.[11] It is necessary to keep the level of debt sufficiently low during normal economic conditions to avoid it exceeding the limit during a possible prolonged economic recession.

8 These calculations are based on the National Accounts data applying on 24 November 2003. There was no possibility to take into account any revisions in the data made since then.

9 The expenditure ceiling for the central government comprises expenditure areas 1 to 27, with the exception of expenditure area 26 (interest on the central government debt, etc.), as well as expenditure for the old age pension system that lies outside the central government budget. This expenditure is known as expenditure subject to the ceiling.

10 In Sweden, consumption and income are taxed at a relatively high rate and transfers are largely based on the principle of loss of income, e.g. compensation for unemployment. This means that public finances are sensitive to fluctuations in economic activity. At the same time, it means that public finances automatically contribute to sustaining demand in a recession and to keeping it down during a boom. This is why it is termed an "automatic stabiliser".

11 The consolidated gross debt comprises the central government debt at nominal value and the local government sector's debts on the credit market, minus the AP pension funds' holdings of government bonds.

The change in the budget process and the introduction of clear budget policy targets have clear parallels to the institutional changes and changes in regulations that formed the basis for the new monetary policy framework.

Budget policy target fulfilment

The consolidation programme was successful. Combined with a relatively good level of economic growth, it contributed to a reduction in the consolidated gross debt from around 74 per cent of GDP in 1994 to 68 per cent in 1998 (see Figure B14). Since the consolidation programme was concluded in 1998, a number of increases in expenditure and reductions in income have been implemented or announced. These include central government subsidies to healthcare, schools and welfare, increased subsidies for families with children and compensation for the introduction of the national pension contribution. Between the years 1998 and 2004, these reforms totalled approximately SEK 168 billion, an amount that exceeds the total savings achieved by the consolidation programme. However, the amounts are not really comparable, as they refer to different years and are based on different monetary values and volumes.[12] The large increases in expenditure and the tax cuts in recent years still raise the question of whether these reforms have been, and are, compatible with the overall budget policy targets.

Expenditure ceiling

The expenditure limited by a ceiling has remained within the ceiling each year since it was introduced in 1997 (see Table B1). According to the Riksbank's calculations, there is some risk that the expenditure target will be exceeded slightly this year if no measures are taken.

Although the expenditure ceiling has not yet been exceeded, the system does not appear to have been applied fully according to the intentions of the budget act. The difference between the *budgeted* expenditure limited by the ceiling and the expenditure ceiling – known as the budgeting margin – shall comprise a buffer against both uncertainty regarding economic developments and factors that may cause unforeseen increases in expenditure, such as increased sick leave. However, there has been a tendency for the budgeting margin to be used for increasing expenditure. In the spring budget bills, the budgeting margin has been set at an average of SEK 23 billion. In the subsequent (autumn) budget bill the budgeting margin has decreased to an average of SEK 16 billion. In the budget for the actual financial year this margin has decreased to only SEK 2 billion on average.[13] This is the small margin that has been available to manage unforeseen events. Consequently, expenditure has tended to be replaced by measures that instead reduce tax revenues. One example is the now permanent employment subsidy of SEK 4.7 billion allocated to the local government sector in the form of a tax reduction.

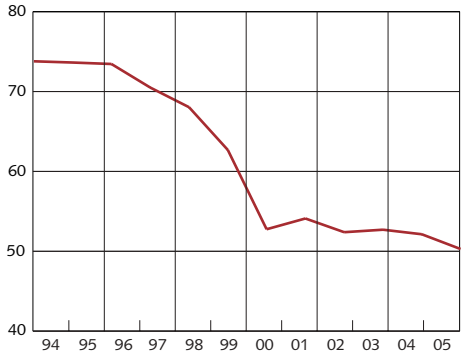
Table B1. Budgeting margin, outcome and forecast. SEK billion

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Expenditure ceiling	723	720	753	765	791	812	822	856	894
Expenditure subject to ceiling	699	718	751	760	786	812	825	856	878
Budgeting margin	24	2	1	5	5	0	-3	0	16

Note. The expenditure ceiling has not been adjusted for technical adjustments.

Sources: The Ministry of Finance and the Riksbank.

Figure B14. Consolidated public sector gross debt, 1994-2005. Per cent of GDP.



Sources: Statistics Sweden and the Riksbank.

12 See Konjunkturläget (The Swedish Economy), March 2003.
13 See the calculations contained in the report "Stabilisation policy in the monetary union", SOU 2002:16, Chapter 5.

The purpose of the expenditure ceiling risks being undermined if the budgeting margin is utilised to increase expenditure and if the central government circumvents the ceiling through reforms that reduce income instead of increasing expenditure.

Surplus target

The surplus target, which was introduced in 2000, can be evaluated by calculating the general government's annual net lending for a whole business cycle. If the net lending is close to 2 per cent on average, the surplus target has been met. The period studied often does not comprise an entire business cycle and a simple average therefore risks being misleading. This applies regardless of whether the target is evaluated in retrospect or looking ahead, based on a forecast. For this reason, the surplus target is sometimes also assessed with the aid of estimates of the structural balance. This measure is intended to show how large the net lending would be if the degree of usage of production resources is at a normal level, that is to say, when the economy is in neither a boom nor a recession. The structural balance is thus a measure of public sector savings that can be directly related to the targeted 2 per cent level. An annual structural balance of around 2 per cent of GDP therefore indicates that the surplus target is met.

The structural balance is usually based on a calculation of the output gap and on budget elasticity. The output gap is an indicator of the degree of utilisation of production resources. When this is at a normal level, the output gap is said to be closed. The budget elasticity indicates how net lending expressed as a percentage of GDP varies according to the level of the output gap. The budget elasticity multiplied by the output gap gives a measure of the cyclical part of the net lending (the cyclical part also reflects the effects of automatic stabilisers on net lending). In an economic boom, the general government's finances are better as a result of tax revenue being higher and expenditure lower than with a normal level of resource utilisation. Correspondingly, savings are lower in a recession as tax revenue is lower than normal and expenditure is higher. The budget elasticity can be estimated to around 0.75. The structural balance is obtained by removing the cyclical part from the actual net lending.

The following example illustrates how the structural balance can be calculated: Let us assume that actual net lending amounts to 3.5 per cent of GDP in a boom, while the output gap is estimated at 2 per cent of GDP. The cyclical part of the net lending will then amount to 1.5 per cent of GDP (0.75x2=1.5). The estimate of the structural balance will then be 2 per cent of GDP (3.5-1.5=2).

Table B2 shows how the *periodised* net lending and the structural balance (with accrual taxes) are estimated to develop between the years 2000 and 2005.[14] On average, net lending with accrual taxes has amounted to 1.8 per cent during this period. The calculated structural balance exceeded the target during the first two years, but was lower than the target in 2002. During the forecast period it is expected to be below the target in 2003 but in line with it during 2004 and 2005.

Table B2. Net lending and structural balance in the public sector 2000-2005. Per cent of GDP

	2000	2001	2002	2003	2004	2005
Net lending	3.4	4.6	1.1	0.5	0.9	1.5
Periodisation of taxes	1.5	-2.0	-0.9	0.2	0.1	0.2
Net lending with accrual taxes	4.9	2.5	0.2	0.7	1.0	1.7
GDP gap	1.2	-0.1	-0.4	-1.1	-1.2	-0.7
Structural balance (with accrual taxes)	4.0	2.6	0.4	1.5	2.0	2.3

Note. The Riksbank uses different methods to estimate the output gap (see also Table B3).

Sources: The Ministry of Finance, Statistics Sweden and the Riksbank.

14 The reported net lending is affected to a large degree during certain years by the incomplete periodisation of tax revenue in the National Accounts. To make a fair comparison of the structural balance over time, it is necessary to adjust the actual net lending for these periodisation effects. The adjusted financial balance is called net lending with accrual taxes.

It should be emphasised that there is great uncertainty attached to calculations of the structural balance and that there are alternative methods, which may give markedly different results. The reason for the differences in the results is often that they give rise to relatively large differences in estimates of the output gap. Table B3 compares the results of three different methods which only differ in their estimate of the size of the output gap:

- A method where the output gap is estimated by weighing together various methods and indicators (this is the method used in Table B2).
- The HP method, which estimates the output gap solely by filtering GDP time series.
- The UC method, which estimates the output gap by relating unemployment to inflation.

Table B3. Structural balance 2001-2005, alternative methods.
Per cent of GDP

	2001	2002	2003	2004	2005
Weighted method	2.6	0.4	1.5	2.0	2.3
The UC method	2.3	0.0	0.8	0.8	1.1
The HP method	1.6	-0.2	1.0	1.6	2.1
Average	2.2	0.1	1.1	1.5	1.8

Source: The Riksbank.

If the average of the structural balance for the three different methods is calculated, it indicates that the surplus target was attained in 2001 but not in 2002. Measured in this way, the surplus target will not be attained in 2003 or 2004. However, it indicates that the surplus target is within reach in 2005.

Overall assessment of target fulfilment
The surpluses in public finances and a relatively high level of economic growth have led to the consolidated gross debt continuing to decline as a percentage of GDP. The debt is estimated to correspond to 50 per cent of GDP at the end of 2005 (see Figure B14), which with satisfies the Maastricht criterion by a broad margin. Despite the fact that the expenditure ceiling does not appear to have been fully applied according to the intentions of the budget act, and that the surplus target has not been attained or is not expected to be attained for the entire period studied, when measured in terms of structural balance, it appears that the overall purpose of the expenditure ceiling and surplus target have been met on the whole. The budget policy targets have contributed to a more disciplined budgetary process and to more stable public finances, which in turn has facilitated monetary policy. This has probably contributed to increasing confidence in economic policy as a whole in Sweden.

However, there are a couple of worrying tendencies. The entire surplus in public sector savings falls within the old age pension system. Many local governments are currently finding difficulty in meeting their balance requirements. In addition, the previous years' surpluses in central government finances have been replaced by a deficit (see Table B4). Throughout the entire forecast period, the central government's financial balance is expected to be negative, which means that the central government debt will increase in absolute terms. Although the consolidated gross debt measured as a percentage of GDP is expected to continue to fall, the higher central government debt means that public finances risk becoming more sensitive to variations in interest rates.

Table B4. Net lending in different sectors.
Per cent of GDP

	2001	2002	2003	2004	2005
Old-age pension system	-4.6	2.0	2.0	2.1	2.1
Local government sector	-0.2	-0.4	0.4	0.0	0.0
Central government	9.4	-0.6	-1.9	-1.1	-0.6
Total	4.6	1.1	0.5	0.9	1.5

Sources: Statistics Sweden and the Riksbanken.

Fiscal stance and fiscal impulse

In addition to an analysis of budget policy target fulfilment, it is also necessary, from a stabilisation policy perspective, to analyse how fiscal policy affects demand in the economy. It is usually necessary to use various economic models to estimate the effects of fiscal policy on demand. However, it is also possible to form a rough estimate of the impact of fiscal policy on demand by studying how net lending varies over time. The change in net lending captures the effect of both the automatic stabilisers and the change in the structural balance. Table B5 shows the change in the Riksbank's forecast of the general government's net lending and structural balance (with accrual taxes) for the years 2002-2005, broken down into various factors affecting the balance. The item "other factors" shows the part of the change in the structural balance that cannot be explained by discretionary fiscal policy in the central government budget, local government tax increases and changes in net capital costs. This "errors and omissions" item captures, for instance, demographic and structural changes, behavioural effects not related to economic activity and composition effects.

Between 2001 and 2002 the structural balance deteriorated significantly, mainly because the discretionary fiscal policy in the central government was strongly expansionary. As resource utilisation deteriorated slightly between 2001 and 2002, there was a slight stimulation effect from the automatic stabilisers. Despite savings measures in the 2003 spring budget bill, decisions on reforms made earlier lead to the discretionary fiscal policy in the central government budget remaining expansionary for this year and next year. As GDP is expected to grow at a slightly slower rate than potential GDP both this year and next year, the automatic stabilisers are expected to stimulate demand. Nevertheless, despite the continued expansionary fiscal policy in the budget, the Riksbank expects the structural balance to improve by approximately 1 percentage point this year. Lower net capital costs and higher local government taxes will contribute to this. The structural balance is also expected to improve in 2004 and 2005, primarily due to the item "other factors affecting the balance". As resource utilisation is expected to improve during 2005, the automatic stabilisers are expected to have a restraining effect on domestic demand.

Table B5. Fiscal impulse
Change as a percentage of GDP.

	2002	2003	2004	2005
Net lending	**-3.5**	**-0.6**	**0.5**	**0.5**
Periodisation of taxes	1.1	1.1	-0.1	0.1
Net lending with accrual taxes	**-2.4**	**0.5**	**0.4**	**0.7**
GDP gap	-0.3	-0.7	-0.1	0.5
Automatic stabilisers	**-0.2**	**-0.6**	**-0.1**	**0.4**
Structural balance (with accrual taxes)	**-2.2**	**1.1**	**0.5**	**0.3**
Of which				
Discretionary fiscal policy in central government budget	-1.8	-0.6	-0.2	0.1
Local government tax increases	0.0	0.4	0.2	0.0
Capital costs. net	-0.1	0.6	0.0	0.0
Other factors	-0.3	0.7	0.5	0.2

Note. Local government tax increases are expected to amount to an average of SEK 0.30 in 2004.

Sources: The Ministry of Finance, Statistics Sweden and the Riksbank.

Future role of fiscal policy

The target for economic policy is usually regarded as being to create a high level of welfare through economic growth, full employment, stable prices, a balance in foreign trade and a "fair" distribution of consumption possibilities among citizens.[15] However, the shaping of economic policy and the importance attached to the different targets has varied over time. At the beginning of the 1990s, economic policy changed direction towards what is usually termed a stability-oriented economic policy. This type of policy is often defined as a set of regulations or institutions that govern monetary and fiscal policy.[16] The emphasis in the economic policy

15 See, for instance, Musgrave, R. A. and Musgrave, P.B., "Public Finance in Theory and Practice", McGraw-Hill Book Company, 1989.
16 See, for instance, Jonung, L. (2002), "Tillbaka till konvertibilitetsprincipen? Penning- och finanspolitiska regimer i ett historiskt perspektiv", (Back to the convertability principle? Monetary policy and fiscal policy regimes in an historical perspective), Appendix 3 to SOU 2002:16.

conducted since the beginning of the 1990s has been on price stability and sound public finances. This should be viewed in the light of the negative experiences of a high, varying inflation rate and a trend of an increasing deficit in public finances. However, there are factors which indicate that economic policy will need to focus more on other aspects in the future.

Although growth in Sweden has been relatively high in recent years, Sweden has lost ground in the welfare league, measured in terms of GDP per inhabitant and compared with similar industrial nations. Growth in the economy is determined primarily by how productive we are and how much we work. Labour productivity, measured as GDP per hour worked, depends partly on the level of education, as well as technological advances and the prevailing conditions for businesses and investment. The number of hours worked depends on many different factors, for instance, how many people are of working age, how many of these are employed, absence from work, etc. Given the increasing number of people on sick leave and the challenges that will ensue from an ageing population, it is important that economic policy should focus on issues that can increase the total labour supply. Aspects that should play a central role here include raising the retirement age, increasing the percentage of those of working age actually in work, greater labour immigration and examining the significance of the taxation and social security systems for the total labour supply.

Economic policy must be directed to a greater extent towards meeting the challenges awaiting us when it concerns the financing of the public sector. The unfavourable demographic developments will probably mean, in the absence of other reforms, that the tax take on the working part of the population will have to be raised in the future. Another factor that risks contributing to this situation is that productivity is increasing at a tangibly slower rate in the public sector than in the private sector, while wage increases in this sector tend to follow those in the business sector. This will lead to an increase in the relative price of public sector goods and services over time, which will in turn put upward pressure on public expenditure. This phenomenon is known as "Baumol's disease". If the tax take is proportional as in the local government sector, tax income will counterbalance the increased expenditure caused by the higher relative price. However, this assumes that public sector consumption's percentage of GDP, measured in terms of volume, is allowed to fall over time. However, if there is a political ambition to preserve a constant volume relationship between private and public consumption, Baumol's disease will unavoidably lead to the necessity of raising the tax take and marginal taxes in the future.[17]

Increasing the already high taxation pressure and marginal tax rates would risk reducing the incentives for labour and investment. Furthermore, the welfare system is facing a number of other challenges, such as the risk of increasing international tax competition.

There are evidently many factors raising questions regarding the future design and financing of the welfare system. It is better to begin such a discussion now, rather than wait until Sweden is in a situation where the problems are already so large that it is difficult to implement the necessary reforms in time. Experiences from the work on introducing the new pension system show that it takes time to bring about more comprehensive changes to the welfare system.[18]

17 In the National Accounts the productivity increase in the public sector is set at zero, because of problems in measuring it. However, for Baumol's disease to prevail, it is not necessary for productivity growth in the public sector to be zero. It is sufficient that the productivity increase is lower than that in the private sector. This is most probably the case.

18 See also the Riksbank's comments on the report "Stabilisation policy in the monetary union" (SOU 2002:16), Ref. no. 02-773-DIR, and on the report "Våra skatter?" (Our taxes?) (SOU 2002:47), Ref. no. 02-2037-DIR.