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Highlights in this issue:

- **Sweden's national budget rules have helped to improve budget discipline and enabled it to easily meet the SGP requirements**
- **However, with the slowdown, increased budget pressure has started to stretch the framework**
- **Rules that help to contain expansionary policies in good times so as to stay within margins in bad times is key, as with the EU**

Swedish budget rules: praise from Brussels, pressure at home

By Jonas Fischer*

Summary

Public finances in Sweden remain strong by EU standards. The national rules-based framework that guides Swedish fiscal policy has contributed to this solid performance. These rules, which complement the EU rules, provide for an ambitious surplus objective for the general government (2% of GDP on average over the cycle), multi-annual nominal expenditure ceilings for central government and a balanced budget requirement for local government. The framework has been successful in promoting prudent fiscal policy, helping Sweden to comfortably comply with EU Stability and Growth Pact (SGP) requirements. Nevertheless, despite the overall positive performance there has lately been increasing pressure in different parts of the framework. The nominal expenditure ceilings have been the most successful rule as they are transparent and operational, carry the greatest political weight and have always been respected despite narrowing margins. The local government budget balance requirement has helped to restrict borrowing but has not fully contained pro-cyclical expansions, which has led to pressure for increased taxes and transfers from central government. While there continue to be overall budget surpluses, lately they have been well below 2% of GDP. On certain aspects, such as how to contain pro-cyclical policies in good times and handle budgetary pressures in bad times, the Swedish rules share similar features with the experience of the SGP rules at EU level and while Sweden's record of compliance with its own rules is clearly better than that of the SGP, there may be some room to enhance positive incentives and improve it even further.

Budget rules: the case of Sweden

A well-designed rule should be adequate, simple and flexible but there are trade-offs

Budget rules can be assessed against a number of desirable features relating to their design and compliance mechanisms (see Buti et al. (2003), Kopits (2001), European Commission (2001, 2003)). A well-designed rule should be adequate in the sense that it contributes to the desired policy goals while being consistent with other policy objectives. It should also be operationally simple; that is, easily understood, well-defined, transparent and enforceable. Moreover, it should be flexible enough to be able to handle changing economic circumstances. Compliance is helped by efficient, transparent and independent ex post reviewing arrangements designed such that the rule cannot be easily overridden or changed. Of course there are trade-offs. Simplicity may come at the expense of flexibility, while a high degree of policy adequacy may require relative complexity at the expense of simplicity. Also, a high degree of flexibility may make a rule less enforceable. These trade-offs, the weight assigned to different features, and the question of how to improve compliance are usually at the heart of any debate on the pros and cons of different

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rules, as has also been the case in the EU debate on the Stability and Growth Pact rules.

In Sweden, as in several other EU countries, the EU rules are complemented by a national framework that emerged after the country's severe budgetary problems at the beginning of the 1990s. It consists of:

- multi-annual nominal expenditure ceilings for central government expenditures;
- a budget balance requirement at local government level;
- a general government surplus objective of 2% of GDP on average over the cycle.

The Swedish framework not only complements the EU rules but is in fact more demanding

To the extent that national rules are compatible with the EU rules they should add to the credibility of the EU framework. The 2%-of-GDP surplus objective over the cycle is more demanding than the SGP objective of "close to balance or in surplus" (CTB) and Sweden has therefore so far been able to live comfortably within the SGP requirements. Complying with the surplus objective helps to ensure long-term sustainability and allows the automatic stabilisers to play freely in downturns. Also, the focus on expenditure control is supported by the literature, which shows that this is a key feature in ensuring durable fiscal discipline. By looking at the experience and record of compliance with the Swedish rules, it is possible to draw some general lessons which are relevant also for the EU budget rules.

Central government: a tight grip on expenditures

Expenditure ceilings are set for 3 years and should include a contingency margin

In 1997, nominal (cash) expenditure ceilings for central government were introduced with a view to setting the budget process in a more controllable medium-term framework where overruns would be compensated by expenditure reductions. The framework requires the government to propose ceilings for the upcoming budget year as well as the following two years. The ceilings cover state budget expenditures and pension expenditures but exclude interest expenditure. The ceilings are adopted by the Riksdag (parliament) and the budget is voted in its entirety, limiting the possibility for discretionary increases under sub-headings. The ceilings should provide room for a contingency margin in order to allow for automatic stabilisers, other unforeseen expenditures and forecast errors. In principle, government agencies cannot transfer expenditures across areas and between years. The framework includes no formal principle – notably a direct link to the surplus objective – on how to set the level of new ceilings. During the first years of the new framework, 1997-2000, the ceilings were set so that expenditures covered by the ceilings were reduced from above 36% of GDP in 1997 to just above 32% of GDP in 2000, but since then the expenditure ratio has been roughly constant (see Table 1) as new ceilings for additional years have been set as a constant share to potential GDP (Budget Bill 2005).

So far the ceilings have been successfully respected….

Overall, the performance of the expenditure ceilings has been very successful. The ceilings have been respected. Moreover, ceilings set for future years (t+2 and t+3) have not been revised upwards in the budgets for those years, which supports the medium-term planning element. The requirement to respect the ceilings carries great political weight and is also closely monitored by other institutions, in particular the National Financial Management Authority (ESV)[1].

…but pressure has increased as contingency margins have narrowed…

However, there have been some recent issues relating to implementation. Contingency margins have often been used to introduce additional spending. The initial contingency margins set for year t+3 shrank to marginal levels at the time of the budget for that year and today there are almost no contingency margins left either for 2005 and 2006 (see Table 2). This may not only hamper the free play of the automatic stabilisers but may also institutionalise the search for last minute corrective expenditure measures under high time pressure in order not to breach the ceilings. Moreover, flexible budget accounting, such as shifting payments across years, has increasingly been used as a way of respecting the ceilings. For example, payment of EU support to farmers and payment of EU contributions has been shifted across years (see Budget Bills 2002 and 2003). Postponement of deliveries of defence material is another example (see Budget Bill 2005). However, simple shifting may not necessarily be a problem, in the sense that it may help reduce the risk of ill-conceived expenditure cuts and, as long as the ceilings are not revised, the challenge to find real expenditure compensation must still be met the following year and is not, therefore, circumvented. More dubious is the tendency to replace what

…making short-term corrective measures necessary

would normally be expenditures (and is therefore restricted by the ceilings) with tax reductions (on the revenue side of the budget and thus not restricted by the ceilings). This may arguably lead to "the purpose of the expenditure ceiling … being undermined" (Swedish Central Bank, 2003) and thus the transparency of the budget process being reduced. Some of the increases in state support to local governments have been funded in this way. The National Financial Management Authority estimates that, in 2005, tax reductions replacing expenditures will be around 0.5% of GDP (ESV 2004)[2]. There has also been a tendency not to set new ceilings for year t+3 according to the normal schedule (ceilings for 2005 were only set in the 2004 budget and the 2005 budget did not contain ceilings for 2007), which may reduce the efficiency of medium-term planning.

Table 1: Central government expenditures 1997-2007

% of GDP	1997	1998	1999	2000	2001	2002	2003	2004	2005*	2006*	2007*
Expenditure ceiling as share of GDP (adjusted*)	36.2	34.3	33.8	32.6	32.6	32.1	32.6	32.5	32.4	32.1	31.7
Actual expenditures as share of GDP (adjusted*)	34.9	34.2	33.8	32.4	32.4	32.1	32.5	32.4	32.4	32.2	32.0
Ex post margin	1.3	0.1	0.1	0.2	0.2	0.0	0.1	0.1	0.0	0.0	0.3
Ex ante contingency margins in Budget Bill for (bn SEK):											
1999	24.1	1.1	3.3	6.4	20.4						
2000		2.0	1.0	1.5	3.7	22.6					
2001			1.5	0.6	1.2	9.2	17.2				
2002					3	2	2	7			
2003						0.3	0.4	0.6			
2004						0.4	0.1	0.2	13.8	28.5	
2005							2.9	0.2	0.2	1.4	*10.0***

*For reasons of comparability across years, the expenditure ceilings are harmonised to take into account technical adjustments (see ESV 2004). Figures over the 2005-2007 period are consistent with the updated 2004 Swedish Convergence Programme (CP).
** Indicative level not based on proposed ceiling (Budget Bill 2005)
Source: ESV, Budget Bills 1999-2005, Updated 2004 CP, own calculations

Transparency and political weight have made the ceilings successful…

…but clearer principles on how to set and use contingency margins could be developed

A strong point in the design of the ceilings is their high level of transparency. Set in nominal terms and directly linked to the budget execution, they make measurement and ex post reviewing by the National Financial Management Authority straightforward. The reputation costs in the event of non-compliance are significant. However, the absence of guidelines on how to set the level of the ceilings and the size and use of the contingency margins imply that consistency with the surplus objective and the aim of avoiding pro-cyclical policies may not always be fully realised. From an operational perspective the expenditure ceilings share certain features with the 3%-of-GDP deficit reference level. The ESA95 accounting system and scrutiny by Eurostat also help make the 3% deficit ceiling transparent and simple. However, while in Sweden the ceilings have been respected even under pressure, at EU level neither supranational peer pressure nor the threat of financial sanctions under the SGP has been able to ensure compliance with the 3% ceiling in several countries.

Local government: a balanced budget rule

Local government is responsible for a large share of government expenditures

Local government in Sweden is responsible for roughly 40% of public primary expenditures and 70% of public sector investment and consumption. Since 2000 a balanced budget requirement has been applied. It stipulates that budgets must plan for revenues higher than expenditures. Local authorities, however, are allowed to borrow to finance investments, but the budget has to bear only the financing cost of the loans (this is different from the accounting conventions in the state budget where, normally, the full investment cost burdens the budget upfront). Should a deficit materialise, there is a clear consolidation rule: own capital must be restored through surpluses within the next three years (until 2004 the time limit was two years). There is, however, no explicit sanction mechanism in the event of non-compliance.

The balance rule has kept surpluses and deficits small on average…

Local income taxes provide roughly two thirds of local government income. Tax rates are set independently on an annual basis and thus vary across municipalities and county councils. The remaining important financial resource is central government grants (amounting to roughly 5% of GDP and included under the expenditure ceilings) which are decided on a discretionary basis and mainly fixed on the basis of population and age structure. Given the responsibilities at local level to provide government services to which citizens are legally entitled there is an implicit "bail-out" commitment from central government to ensure local services at a guaranteed level.

…but expenditure growth in good times has created budgetary distress in bad times

As can be seen in Table 2, the local authorities have generally recorded small surpluses or deficits on aggregate, broadly in line with the rule. In the late 1990s and the first few years of the new millennium, local revenue growth was healthy, which allowed an expansion of consumption. Subsequently, with the economic slowdown, local revenues faded while demand for local government consumption increased. As a result many municipalities and county councils suddenly found themselves in financial distress and local governments had to introduce structural savings and raise local taxes. Accordingly, income tax rates at the local level were raised by more than 1 percentage point over 2003-2004, reducing take-home pay at the margin (NIER 2004) and largely cancelling out the central government's efforts to further reduce taxes on labour. Moreover, the central government responded with significant increases in state support to uphold local services (directly contributing to the widening of the central government deficit).

Overall, the balanced budget requirement has been successful in limiting local borrowing. Nevertheless, it seems that, in combination with the implicit commitment from the central government to step in in case of financial distress, it may create incentives for expansionary policies in good times, when revenue growth is healthy, and to rely on additional central government transfers in bad times. This is a typical problem of moral hazard and may call for a tighter rule but, as in the EU, there is a limit to the restrictions that can be imposed from the centre while respecting independence at the lower level. Of course, in the EU, the no-bail-out clause included in the Treaty is aimed at mitigating this type of moral hazard.

General government: surpluses maintained but below the 2% objective

Meeting the 2% surplus objective over the cycle helps reduce debt levels

The surplus objective of "2% of GDP on average over the cycle" has been operational since 2000. The level of the surplus is intended to secure a reduction in net debt levels to address the budgetary impact of ageing populations. Table 2 shows budget figures consistent with the Swedish updated convergence programme for 2004. While there have consistently been surpluses, since 2002 the overall surplus has been well below 2% of GDP, following increasing central government deficits. Over this period, local governments have generally recorded small deficits or surpluses, as would be expected given the balance requirement, while the social security sector (i.e. including the pension system) has recorded stable surpluses of around 2% of GDP[3]. Hence, meeting the 2% surplus objective would require a balanced central government budget over time, whereas in fact, since 2002, the central government has posted a deficit of around 1.5% of GDP.

Continued surpluses but well below 2% of GDP since 2002.

A problem when assessing the extent to which budget positions or budget plans are in compliance with the surplus objective "on average over the cycle" is that there is no method within the framework for calibrating "the cycle" and measuring surpluses against it. As these variables are not directly observable and a variety of possible estimates are available, the lack of an agreed method makes it difficult to clearly assess compliance. Also, it is not clear how "on average" should be understood. In the 1998-99 convergence programme update it was indicated that a cyclically-adjusted budget balance (CAB) concept might be used for this purpose[4] while in recent years reference has been made to the average of nominal balances since the year 2000, the first operational year of the objective (see for example the 2004 convergence programme update). Unlike the CAB figure for an individual year, the average approach allows the large surpluses recorded in 2000 and 2001 to be taken

…but it remains unclear how compliance should be assessed and what the policy implication of non-compliance is…

into account. However, even with this interpretation, meeting the 2% surplus objective is challenging. For example, it is straightforward to calculate (on the basis of the figures in Table 2) that, to allow the average deficit over the 2000 to 2010 period (which should arguably cover at least one business cycle) to be 2% of GDP, surpluses of 3.5% to 4% of GDP would be necessary in the 2008 to 2010 period, implying a very ambitious consolidation strategy in future years (European Commission 2005). Nevertheless, as there are no clear principles within the framework for what should be the policy response in the event of a departure from the objective, it is not clear what the implications are for future policy in practice.

Table 2: Budget developments 2000-2007

% of GDP	2000	2001	2002	2003	2004	2005	2006	2007
General Government	5.1	2.8	0.0	0.5	0.7	0.6	0.4	0.9
Central Government	2.7	7.6*	-1.5	-1.4	-1.3	-1.8	-1.8	-1.2
Local Government	0.2	-0.2	-0.6	-0.2	0.1	0.3	0.3	0.2
Social security sector	2.2	-4.6*	2.0	2.0	2.0	2.1	1.9	1.9
Average balance from 2000	5.1	4.0	2.6	2.0	1.8	1.6	1.4	1.4
Cyclically-adjusted balance (COM)	4.2	3.1	0.5	1.4	0.8	0.5	0.5	1.2
Output gap estimate (COM)	1.3	-0.4	-0.8	-1.4	-0.1	0.1	-0.2	-0.4

***** The atypical sector balances in 2001 are explained by the one-off transfer of 155 bn SEK from the pension system to the state as part of the pension reform.
Note: Cyclically-adjusted balances and output gaps are calculated by the Commission using the common EU method on the basis of the figures in the updated Swedish CP 2004.
Source: Updated Swedish CP 2004, European Commission (2005)

…so efforts to increase transparency may improve efficiency

All in all, the surplus objective is economically adequate in its design since it helps to address long-term sustainability while also allowing business cycle fluctuations to be taken into account. However, the uncertainty as to how the objective is interpreted and compliance assessed appear as weak points. A comparison can be made with the SGP's "close to balance or in surplus" medium-term requirement (CTB) which is of the same qualitative nature. At EU level substantial efforts have been put into making the CTB more transparent by developing common understandings on its interpretation and by defining a common methodology for measuring the cycle and the budgetary impact of the cycle (See Commission 2001 and 2003). There are also external reviewers in the Commission and the Council. Despite these efforts, there have been extensive problems with compliance and enforcement at EU level, partly owing to the absence of any real sanction mechanism beyond peer pressure and reputation to support the CTB requirement, indicating that moral hazard is higher with supranational rules (Buti et al. 2003). A common feature of these problems seems to be the weakness of the incentives to enforce compliance in good times so as to ensure room for manoeuvre in bad times and thus safeguard credibility.

Conclusion

The Swedish framework has helped to nurture a culture of budgetary prudence and medium-term planning…

The budgetary rules in Sweden have effectively served to nurture a culture of budgetary prudence and medium-term planning and the budgetary performance in Sweden is consequently clearly better than in large euro-area countries. The main success has been the multi-annual nominal expenditure ceilings. They carry the highest political weight of all the rules and have consistently been respected even though margins are increasingly narrow. Their credibility is enhanced by their transparency. The 2% surplus objective, however, is less transparent and the absence of clear principles for the follow-up and review process makes the budget policy implications of non-compliance unclear. The budget balance requirement at local level has made it possible to restrict borrowing even though expansionary policies in good times have led to pressure to increase taxes and central government transfers.

An issue in all three parts of the framework seems to have been how to restrain expansionary policies in good times, which leads to pressure to tighten policies in bad times when the rules start to bite. This in turn creates incentives to find ways to circumvent the restrictions. Possible ways of strengthening the framework may be to make the medium-term surplus objective more transparent to allow efficient

...but how to deal with good and bad times has been an issue, as it has at EU level, even though Sweden's compliance record is clearly stronger

monitoring and follow-up, and to introduce clearer principles for the setting of expenditure ceilings – possibly with a direct link to the surplus objective – and include principles for the size and use of the contingency margins in order to improve consistency and predictability. Finally, the design of the balance requirement at local level could be re-assessed with a view to ensuring prudence in good times[5]. The debate at EU level on the experience with the SGP rules indicates some common features with Sweden, notably the issue of ensuring prudence in good times and the challenge of handling budgetary pressure in bad times. However, while Sweden's budgetary position remains healthy, weaker application and compliance at EU level has led to high structural deficits (especially in large Member States), making the need for reform more urgent.

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[1] The ESV (The Swedish National Financial Management Authority) analyses central government finances and makes regular estimates of the outcome of the central government budget, including government expenditure in relation to the ceiling on expenditure and the budget balance with a view to identifying any risks to public finances at an early stage.

[2] It is worth noting that in the national accounts (ESA95) these "tax expenditures" are predominantly booked on the expenditure side (ESV 2004).

[3] The pensions system is recording surpluses of 2% of GDP, as a result of the favourable demographic situation. This surplus is expected to be gradually reduced towards 1% over the next 10 years (ESV 2004). Furthermore, in March 2004, Eurostat decided that defined-contribution pension schemes should be classified outside the government sector. Sweden benefits from a transition period to implement this accounting rule but should apply it from March 2007, implying that the 1% of GDP surplus in these schemes will no longer contribute to the general government budget balance, something that may call for a technical reformulation of the 2% objective.

[4] The 1998-99 update stated that "..the actual budget surplus could fall below 2% of GDP in a phase of the business cycle with relatively idle capacity in the economy but conversely exceed 2% of GDP in the peak phase of the business cycle. Thus, the level that the budget surplus will reach in an individual year is dependent on the phase of the business cycle which provides scope for the automatic stabilisers to work."

[5] Some of these issues were discussed in the government report on stabilisation policy in a monetary union (SOU 2002:16) made in preparation for the referendum on EMU in 2003. Also, in the Budget Bill 2005, the government signals its intention to look at the principles for setting and using the contingency margins under the expenditure ceilings.

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