Experience of Fiscal Rules in Sweden

Meeting with the Budget Committee
of the Armenian Parliament

Joakim Sonnegård & Niklas Frank

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FINANSPOLITISKA RÅDET
SWEDISH FISCAL POLICY COUNCIL

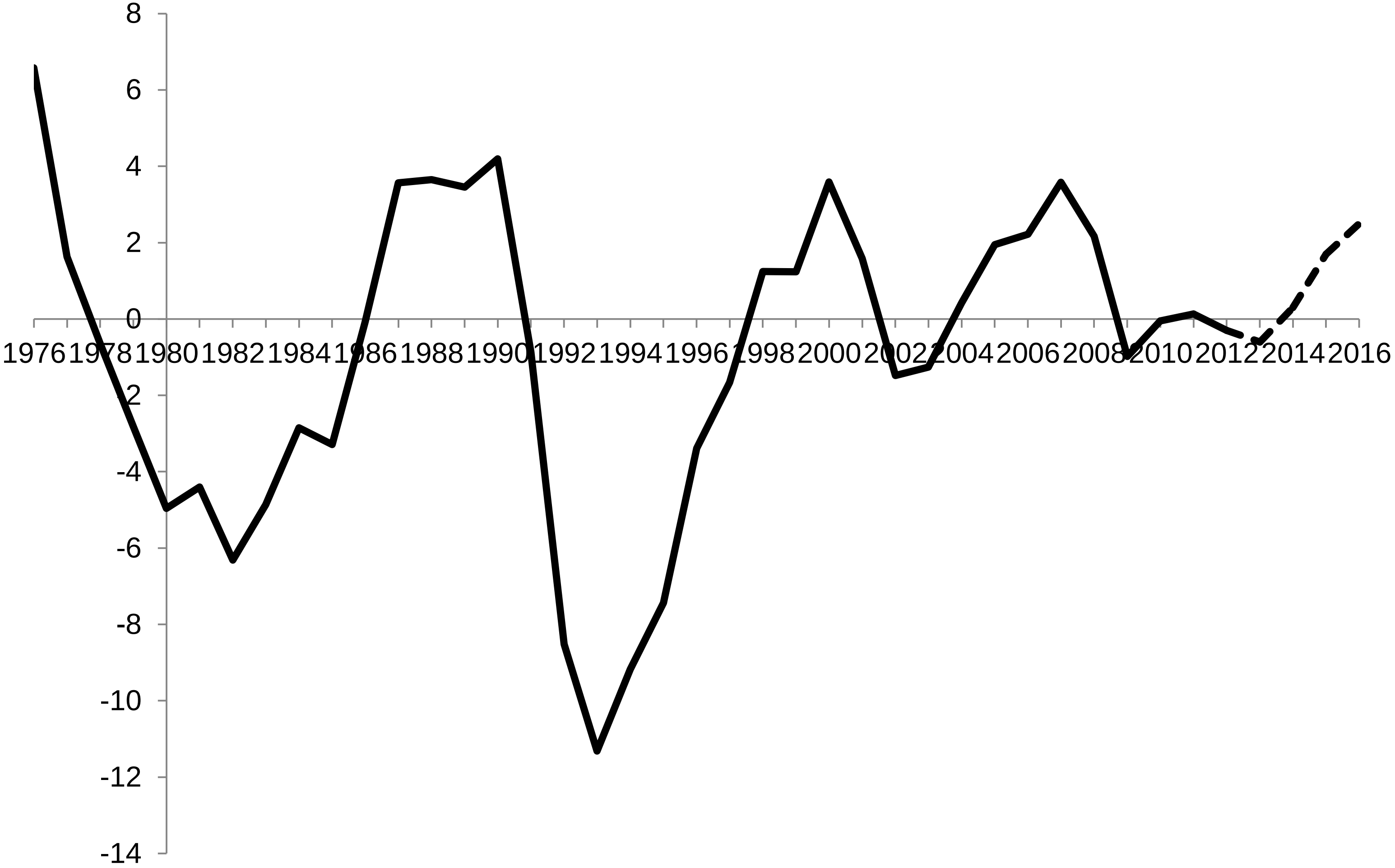
Background

1990-2007: a summary

Sweden during the Recent Crisis

- Despite a 5% drop in GDP in 2009 and a typically high fiscal balance elasticity, Sweden:
  - Moderate drop in the fiscal balance;
  - Modest maximum deficit of 1.0%. Now (more or less) in balance;
  - Recovered to pre-crisis GDP in 2010.
- Very different from the crisis in the early 1990s: similar amplitude in GDP fall, *but* at that time an extreme deterioration of public finances and rise in unemployment. Long recovery.
- Key explanations for Sweden's good performance:
  - Important reforms were undertaken during the 1990s;
  - No structural imbalances – no domestic amplification mechanisms;
  - Strong budget before crisis due to well-functioning fiscal framework;
  - A conservative Finance Minister determined not to repeat mistakes;
  - Luck…

General Government Net Lending as % of GDP 1976-2016



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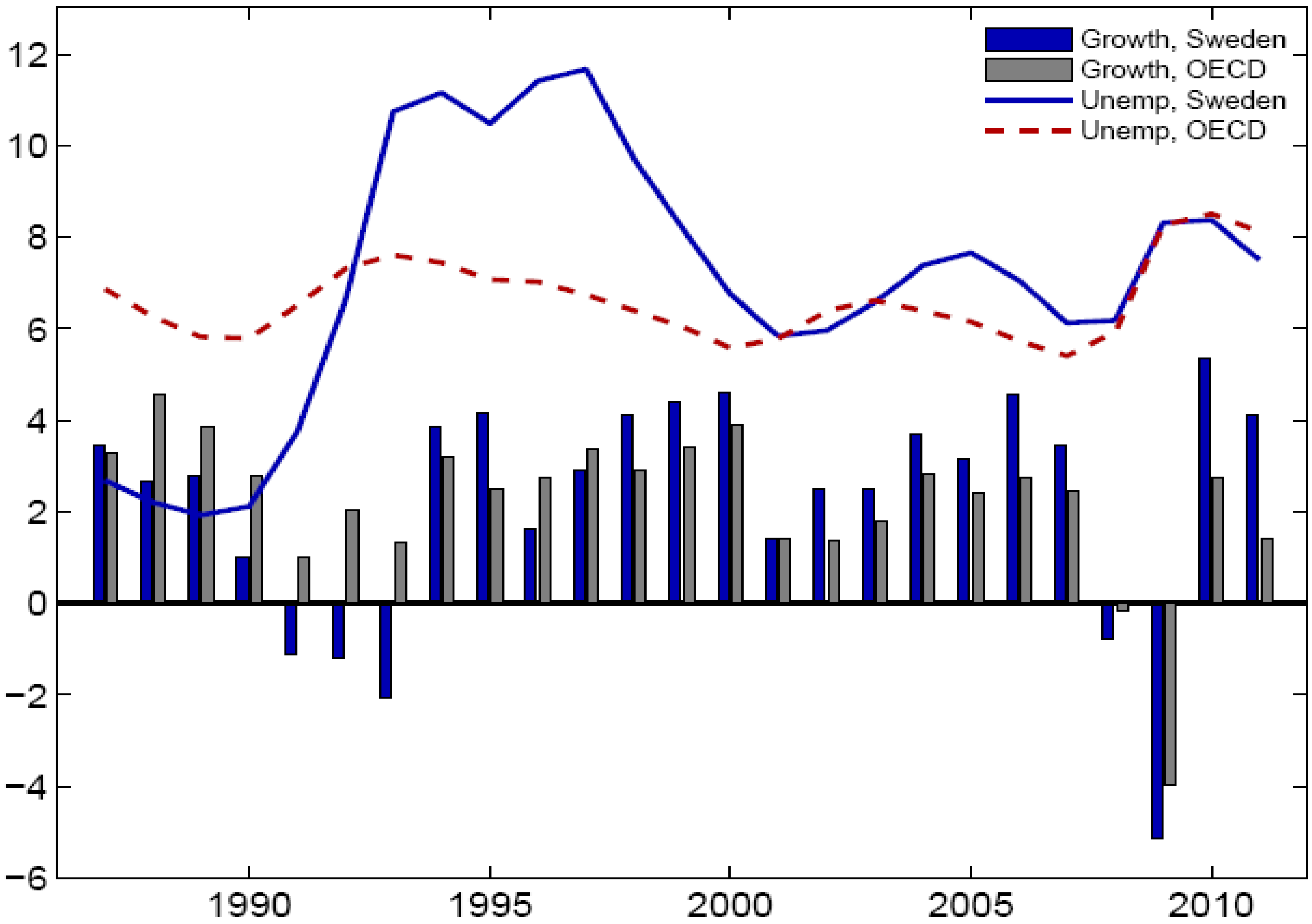
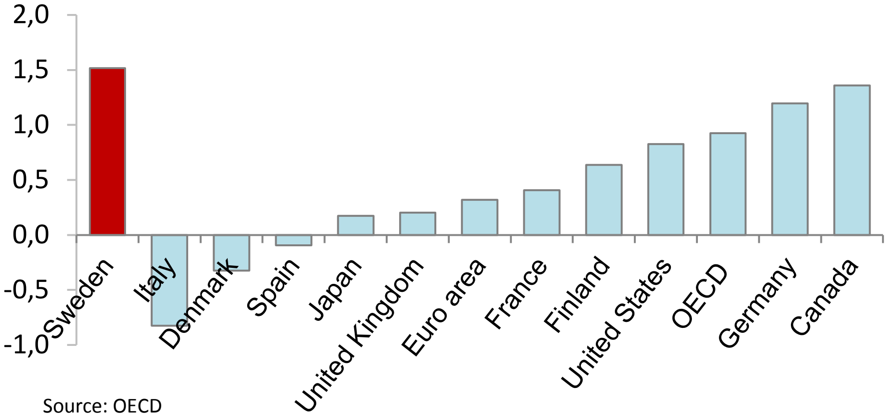
Growth and Unemployment 1985-2011



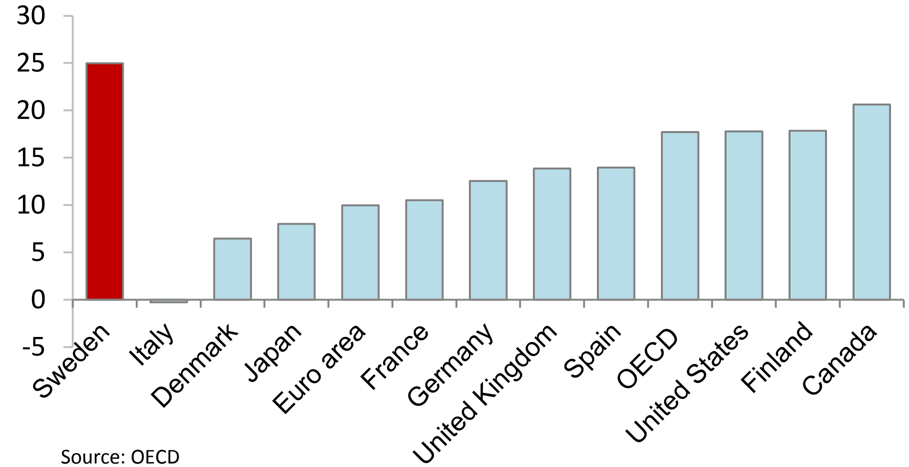
Note: Growth rate of GDP (percent) in Sweden and weighted average of 19 OECD countries.
Source: OECD Economic Outlook December 2011.

Annual average real GDP growth
(%) 2007-2012



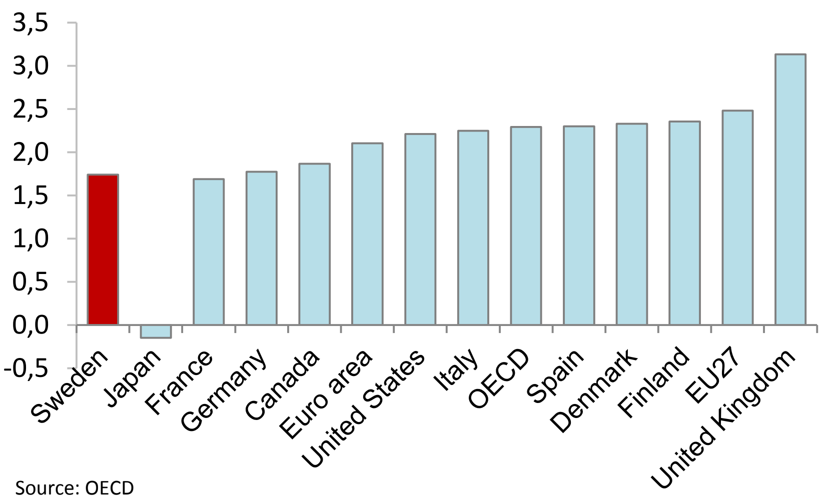
Source: OECD

Total real GDP growth
(%) 2002-2012



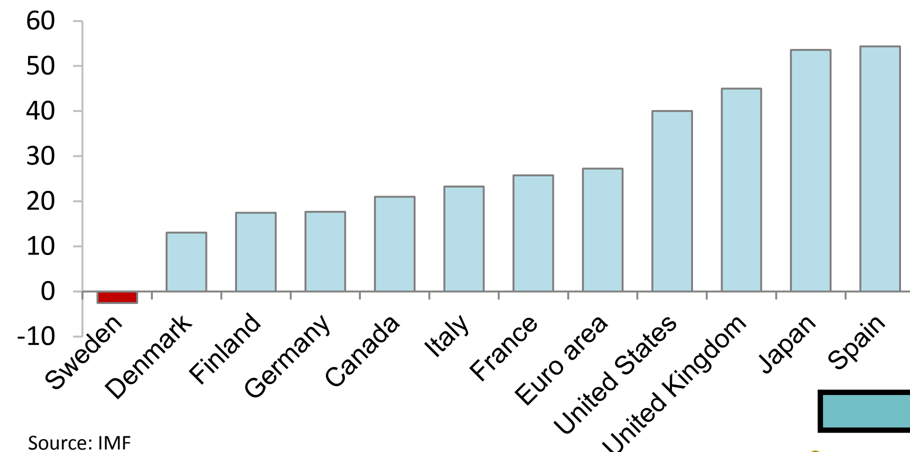
Source: OECD

Annual average inflation rate
(%) 2007-2012



Source: OECD

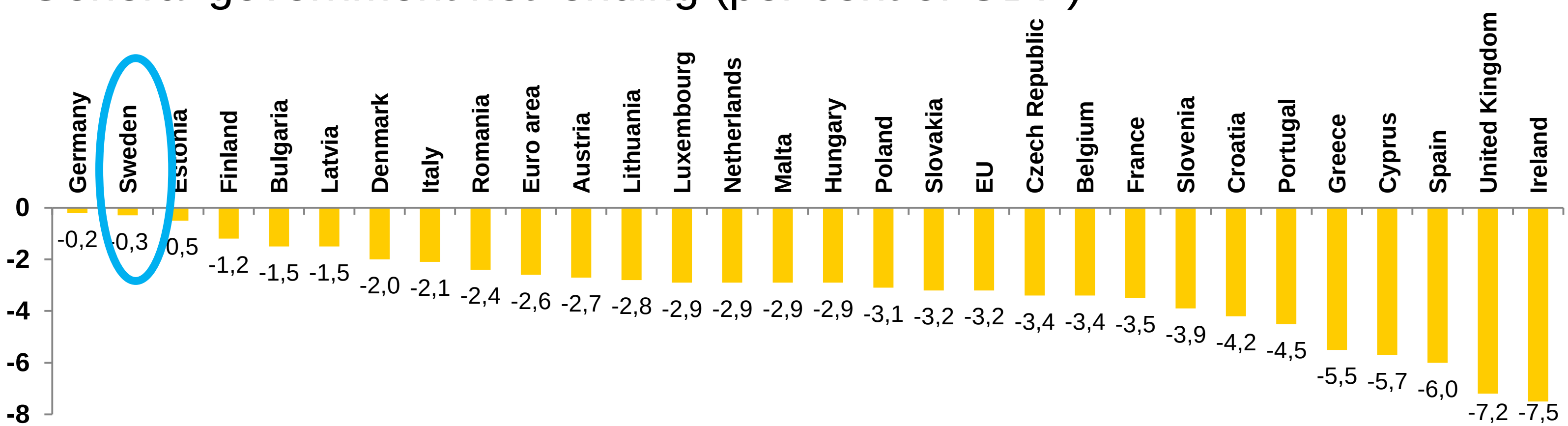
Change in government gross debt (as % of GDP)
(percentage points) 2007-2012



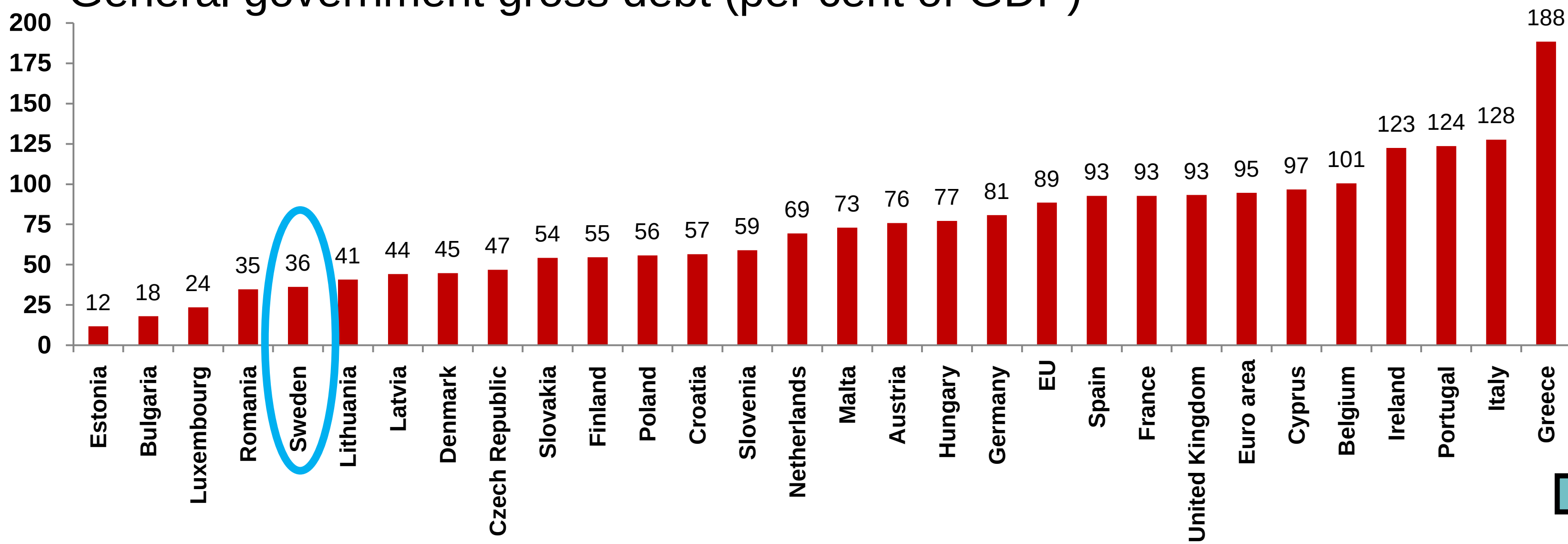
Source: IMF

Public finances 2013

General government net lending (per cent of GDP)



General government gross debt (per cent of GDP)



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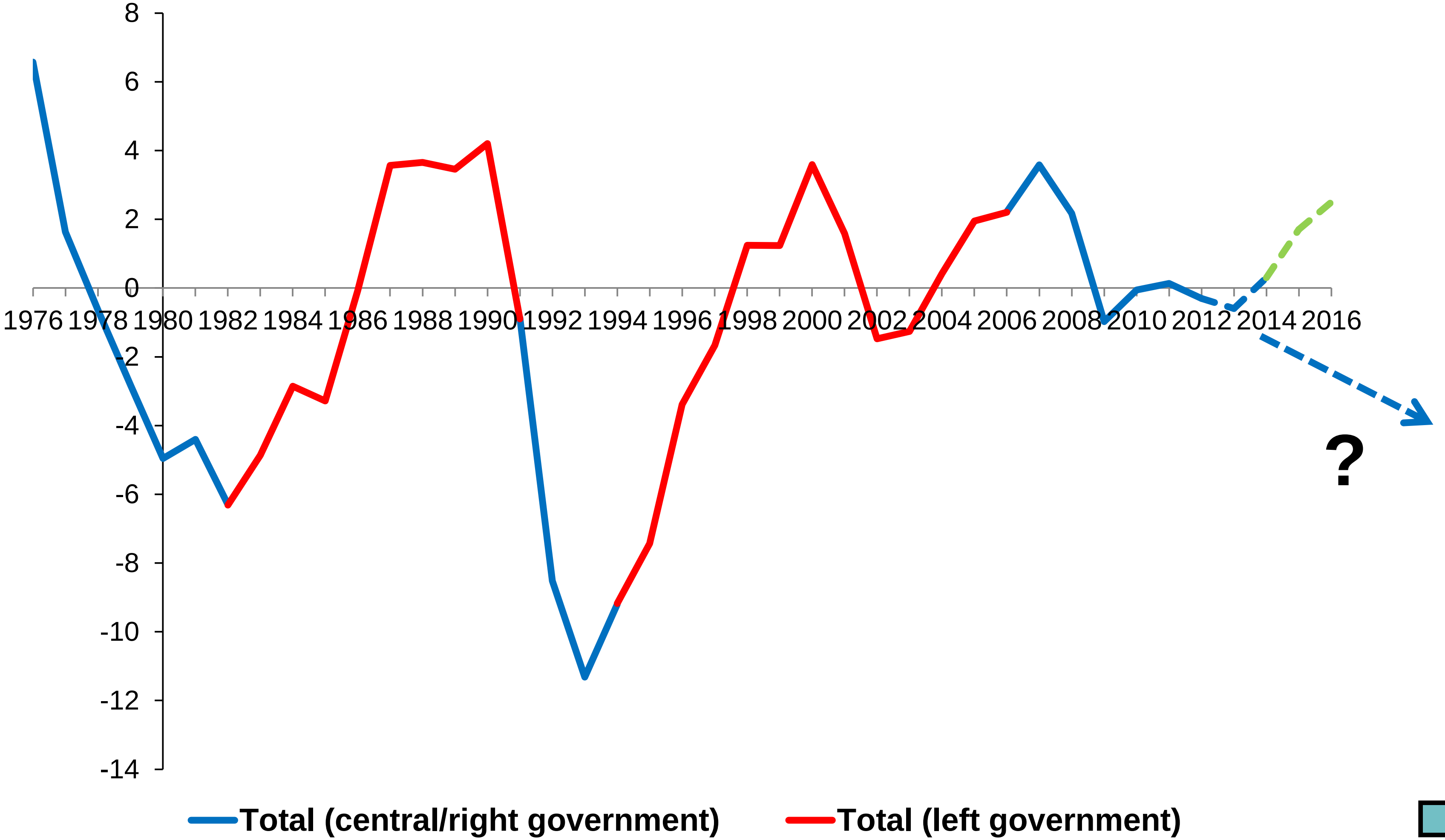
Source: European Commission, Autumn economic forecast 2012

General Government Net Lending as % of GDP 1976-2016



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Background to Reforms

- Sweden suffered a deep economic crisis in the 1990s:
  - Credit market deregulation in the 1980s led to rapid credit expansion;
  - Rapidly increasing property prices, then a collapse;
  - Banking crisis;
  - Large real appreciation leading up to the crisis;
  - Exploding unemployment rates;
  - Very high interest rates;
  - Structural problems became apparent (tax system, pension system, wage formation, long run growth…).
- Relatively similar to the current crisis in Spain.
- Crisis created a wide consensus on the need for a major *makeover.*

A Comprehensive Makeover

- A new tax system:
  - Corporate taxes cut in half;
  - Marginal top income taxes reduced from 70% to 50%;
  - VAT tax base broadened.
- Insolvent banks were taken over and split into good and bad banks. Ultimately not a bad deal for tax payers;
- EU membership in 1995;
- Election periods extended to 4 years;

…A Comprehensive Makeover

- Stricter competition law; deregulation and privatizations of rail, telecom, taxi, schools, post, electricity;
- Tough fiscal consolidation (1993-1998, ~ 11% of GDP);
- Delegation of monetary policy to an independent central bank with an inflation target. Large initial depreciation;
- A new contributions-defined pension system, immune to variation in growth and demographics, was introduced;
- A new Fiscal Policy Framework.

Lessons from the Crisis in the 1990s

- **Structural problems must be identified early**
  - Crisis often reveals structural problems;
  - Automatic stabilizers, fiscal policy and social safety nets work well for temporary shocks in countries with no structural problems.
- **All reasons for deficit bias need to be identified and addressed**
  - Common pool, information, time consistency.
- **Mandate for change**
  - Crisis creates a window of opportunity for change;
  - A broad political *and* popular support for reform is a necessary precondition. A political *story* is needed;
  - "Someone" else is not going to pay;
  - Institutional reforms can peg down and enhance institutional memory.

Are the Swedish Experiences Relevant for Current EU Crisis Countries?

- Key issues to take into consideration:
  - Export-led growth through currency depreciation and strong external demand were key components in the Swedish recovery;
  - The substantial consolidation of public finances was implemented <u>after rapid growth had resumed</u> in the Swedish economy (1995-1997).

Note that:

  - Strict Swedish monetary and fiscal policy implemented around 1995 had contractionary effects on the economy.

The Swedish Fiscal Framework

The Swedish Fiscal Framework

- Top-down budget process (preparation in Government as well as decision in Parliament);
- A fiscal *surplus target* for general government net lending of 1% of GDP, on average, over the business-cycle;
- Central government *expenditure ceiling* set 3 years in advance; decision by Parliament;
- Balanced budget requirement for local governments;
- Since 2007, a Fiscal Policy Council with a broad remit (to facilitate transparency and accountability).
- *Note: The strength of this framework depends on the political will to respect it…*

The Council's background

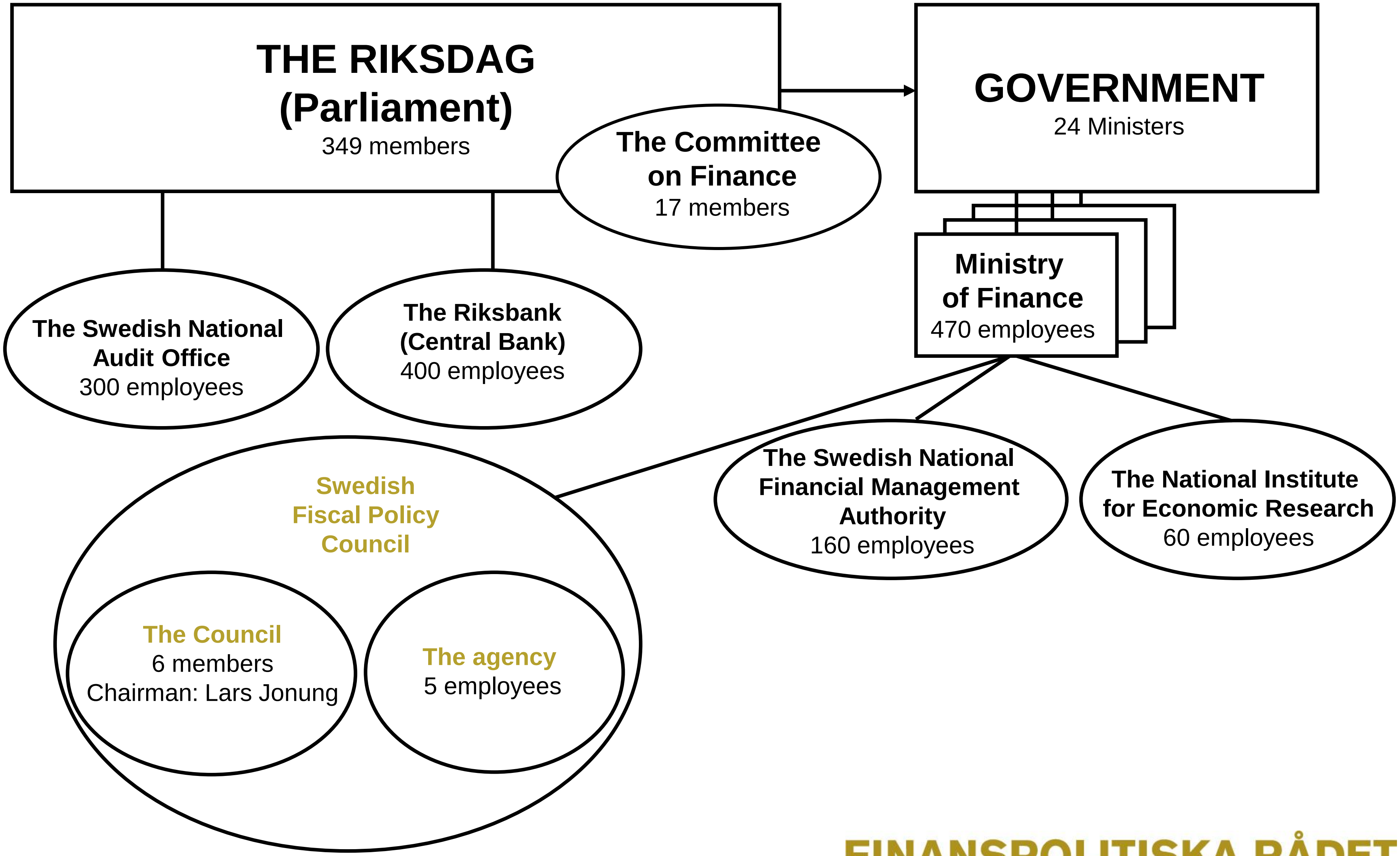
- Theoretical considerations rather than acute problems;
- Government Commission in 2002: requirements on fiscal policy in the event of euro membership;
- Positive reactions from the liberal-conservative parties (Anders Borg);
- Negative reactions from the Social Democrats, the Left and the Greens:

  another body providing false scientific clothing for the government's right-wing policy

- However, the liberal-conservative government reached an agreement with Social Democrats, the Left and the Greens in May 2011 on the existence of the Council (including a new remit).

The set-up of the council

- Established in 2007;
- An agency under the Government;
- Six members:
  - Academics;
  - Policy-making experience;
- Supplementary activities to ordinary jobs (mainly academic positions);
- Small secretariat: five persons;
- Annual budget 900 000 €;
- Provisions to safeguard the Council's independence, such as a stipulation that the Council itself proposes its members to the Government.


THE RIKSDAG
(Parliament)
349 members
GOVERNMENT
24 Ministers
The Committee on Finance
17 members
Ministry of Finance
470 employees
The Swedish National Audit Office
300 employees
The Riksbank (Central Bank)
400 employees
Swedish Fiscal Policy Council
The Council
6 members
Chairman: Lars Jonung
The agency
5 employees
The Swedish National Financial Management Authority
160 employees
The National Institute for Economic Research
60 employees

The tasks of the Fiscal Policy Council

1. Focus on *ex post* evaluation
2. Evaluate whether the fiscal policy meets its objectives:
   - Long-run sustainability;
   - Compliance with Surplus target and expenditure ceiling
   - Stabilization issues.
3. Evaluate whether the developments are in line with sustainable growth and a sustainable high employment;
4. Monitor the transparency of the budget proposals and the motivations for various policy measures;
5. Analyze the effects of fiscal policy on the distribution of welfare;
6. Contribute to a better economic policy discussion in general:
   - Annual report in May (this year May, 15);
   - More information on ***www.finanspolitiskaradet.se***.

Themes in the reports

- Increase the clarity of the surplus target (net lending of 1% of GDP over a business cycle):
  - Underlying fundamental objectives
  - Methodology for monitoring
- Criticism of circumventions of the expenditure ceiling;
- Critical evaluation of the fiscal sustainability calculations;
- Request for additional discretionary fiscal stimulus in the current recession (but less of permanent measures);
- Critical evaluation of the Government's labor market reforms.

Has the fiscal policy framework worked?

- Generally successful implementation:
  - Top-down approach is followed;
  - Spending ceilings have not been breached (albeit some minor, and politically costly, examples of creative bookkeeping);
  - Surplus target has been met – at least until now… (various indicators used);
  - Broad political support: opposition wanted more spending during crisis, but less than 1% of GDP;
  - The Fiscal Policy Council has increased the transparency and facilitated a higher quality of the political discussion.