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Application of the fiscal policy framework

The Government's presentation in the budget bill for 2010

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Application of the fiscal policy framework

The Government's presentation in the budget bill for 2010

The Swedish National Audit office has audited how the Government has applied the fiscal policy framework in the budget bill for 2010. The result of the audit is presented in the audit report.

Representatives of the Governemnt Offices have had the opportunity to factually scrutinise the report and otherwise state their views on the draft final report.

The report is submitted to the Government in accordance with section 9 of the Act (2002:1022) on auditing of government activities, etc. A copy of the report is also submitted to the Advisory Board of the SNAO. The SNAO will follow up up the report.

Auditor General *Eva Lindström* had decision-making authority in respect of this report. Audit director *Thomas Hagberg* was responsible for the presentation of the report. The Senior Audit Director, *Tomas Nordström*, assisted in producing the final version of the report.

Eva Lindström　　　Thomas Hagberg

For the information of:
Swedish Fiscal Policy Council

Content

Summary

Fiscal policy is governed by three comprehensive targets:

- The surplus target means that the public sector's net lending should yield a surplus equivalent to 1 per cent of GDP on average over a business cycle.
- The expenditure ceiling for the central government entails that its expenditures are limited to an amount, in SEK billion, which is decided upon three years in advance.
- The balance requirement means that single municipalities and county councils must not adopt a budget in which expenditures exceed revenues.

The Swedish National Audit Office (SNAO) regularly audits the Government's application of the framework in the fiscal bills. The aim is to contribute to a comprehensive and clear presentation of fiscal and budgetary policies to the Riksdag, the Swedish parliament, and the general public. A transparent presentation of the orientation of fiscal policy in relation to the budget targets strengthens confidence in fiscal policies and contributes to a stable economic development. The presentation of fiscal policy has improved in several aspects over the past years. The establishment of the Fiscal Policy Council in 2007 has resulted in increased external surveillance.

As a result of the crisis in the financial markets, the international and the Swedish economy has weakened substantially. The Government has taken a series of measures to stabilise the economy. The measures have been presented to the Riksdag in several bills since the budget bill for 2009. In the budget bill for 2010, the Government proposes and announces additional reforms and measures to stabilise the economy. Taken together, these measures weaken public finances for the period 2010–2012 with SEK 32, 24 and 22 billion, respectively.[1] The expansionary fiscal policy and the weakened real economy entail strongly worsened public finances compared to the budget bill a year ago. To maintain confidence in public finances, it is especially important in this particular situation that the monitoring of the budgetary policy targets and the Government's strategy to meet the surplus target is presented comprehensively and clearly. It is in times of crisis that the Government's application of the fiscal framework is put to the test.

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1 In 2011 and 2012, an effect arises due to a reform of SEK 6.5 billion on the pensions area. It is designated in the budget bill as an "assumption for estimation purposes" and is not shown among other suggested or announced reforms, see section 4.2.

The fundamental motive for the fiscal framework is to secure the public finances' long-term sustainability. The budgetary policy targets aim to minimise the risk that temporary deficits become permanent and develop into a debt crisis. Therefore, besides an audit of the Government's monitoring of the budgetary policy targets, we also bring up the Government's analysis of the public finances' long-term sustainability in this report.

Observations and conclusions

A pre-requisite for a sustainable development of public finances is a clear presentation of the demands that are put on the fiscal policy's orientation. The SNAO notes that the Government's sustainability analysis, in spite of its many merits, leads to the paradoxical conclusion that the public sector's finances are not sustainable in the long-term, despite of a growing surplus all through this century.

The long-term picture of development of public finances, which the Government presents in the budget bill, shows that net lending gradually has to increase in addition to the surplus target that the Riksdag has decided upon. The surplus exceeds 1 per cent of GDP for the entire period up to 2099. The Government does not comment on the sustainability calculation's implication on the surplus target's level and adequacy.

The SNAO also establishes that the Government's presentation of the deviations from the surplus target is still inadequate. The indicators that the Government uses for monitoring the target point towards totally different, and in some cases, very large deviations. It is unclear which role the indicators play for the Government's orientation of fiscal policy from now on. A clear presentation of the target deviations and how the Government intends to reduce them is especially important in a situation where public finances are weak and the policy's long-term sustainability risks being questioned.

The expenditure ceiling is the main tool to secure the surplus target and long-term sustainability of fiscal policy. The Government's proposal for the expenditure ceiling for the third year to come should, therefore, be clear and fully justified in relation to both the surplus target as well as taxes required. However, the Government does not present any account of the proposal for the 2012 expenditure ceiling.

The proposal for the 2012 expenditure ceiling is SEK 10 billion less than in the assessment presented in the spring fiscal policy bill. The Government's explanation is that a more restrictive expenditure policy can be necessary to reach the surplus target. However, at the same time, the forecast for pension expenditures is lowered by more than SEK 10 billion, as a result of an incorrect calculation in the spring fiscal policy bill. According to the SNAO, the cutback on the expenditure ceiling could rather be seen as a consequence of the correction of the miscalculation in the pension expenditures.

A previously set expenditure ceiling is of vital importance for the budget process. The ceiling compels prioritising expenditures in the preparation and execution of the central-government budget. The confidence in the expenditure ceiling, however, can be damaged if different types of technical accounting measures are used to circumvent the ceiling. The payment at the end of 2009 of the temporary support to local-governments for 2010 is such an example.

The local-government sector represents 20 per cent of the economy and is accountable for the majority of the tax-financed welfare services. To secure responsible financing, the Local Government Act demands "sound financial management" in individual municipalities and county councils. According to the act, it is not allowed to adopt a budget where costs exceed revenues (the so-called balance requirement). In the 2009 audit of the spring budget bill, the SNAO commented that the presentation of the local-government sector's finances was too split up among different sections in the bill and that the implication of a forecast where the local-government sector is assumed to breach the balance requirement was unclear. The presentation has improved in the budget bill. The forecast indicates that the balance requirement is met. However, this presupposes a large increase in productivity of local-government activities in 2011. The Government neither comments upon nor motivates this assumption, despite the fact that the increase in productivity is a necessary condition for the local-governments to manage the balance requirement set by law.

Recommendations

Based on the observations and conclusions presented above, the SNAO wishes to make the following recommendations:

- The Government should review the analysis of fiscal policy sustainability and the application of the so-called S2-indicator. The sustainability analysis should be related to an assessment of the desired surplus target level.
- The Government should clarify the role that different target indicators play in the evaluation of deviations from the surplus target, and for the orientation of fiscal policy in the coming years.

- In relation to the ongoing review of the fiscal framework, the Government should consider an alternative formulation of the surplus target that allows for a more precise presentation of the deviations from the target.
- The explanations given for the expenditure ceiling level and the increased budgetary margins for 2012 are insufficient considering the large deviations from the surplus target. The Government should specify how the proposed expenditure ceiling for the third year to come will contribute to meeting the surplus target.
- The Government should refrain from creating more scope for expenditures in the coming fiscal year by bringing forward expenditures by technical accounting measures in supplementary budgets. The accounting principles for the budget should be treated in the ongoing review of the fiscal framework.
- The Government should continue to develop the presentation of the local-government sector's finances in the fiscal policy bills; for example, by relating the forecasts to the balance requirement as well as to the demand of sound financial management. Possible gaps between the forecast and the Local Government Act's demands should be commented on. Comparisons with the forecast in the previous bill are a good way to clarify the current assessment. Large differences should be explained.

1 Introduction

The SNAO regularly audits the Government's application of the fiscal framework in the fiscal policy bills. The purpose is to contribute to a comprehensive and clear presentation of fiscal and budgetary policies to the Riksdag and the general public. A transparent presentation of the policies in relation to the fiscal targets strengthens the confidence in fiscal policy and contributes to stable economic development.

The fiscal framework that, since 2000, governs fiscal policy contains three fundamental budgetary policy targets[2]:

- The surplus target means that the public sector's net lending must yield a surplus equivalent to 1 per cent of GDP on average over a business cycle.
- The expenditure ceiling means that expenditures in the central-government budget's expenditure areas, excluding expenditure area 26 'Interest on the central-government debt, etc.' and including expenditures for the system of old-age pensions, are limited by a nominal amount in SEK billion decided three years in advance.
- The balance requirement means, according to the Local Government Act (1991:900), that individual municipalities and county councils must not adopt a budget where expenditures exceed revenues. If operations still give a negative financial result, this must be compensated for with an equivalent surplus within three years. The balance requirement should be seen as a minimum. The law's requirement of "sound financial management" presupposes permanent surpluses.

During the past year, both the international and the Swedish economy have been greatly weakened due to the financial crisis. The Government has taken a series of measures to stabilise the economy. The measures have been presented to the Riksdag in several bills, since the budget bill for 2009. During the reading of the 2009 spring budget bill, the Riksdag decided upon additional measures to stabilise economic development. In the budget bill for 2010, the Government proposes and announces additional reforms and measures to stabilise the economy. All together, these new measures weaken public finances for 2010–2012 with SEK 32, 24 and 22 billion, respectively.[3]

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2 The terms "budgetary policy targets" and "fiscal policy targets" have the same meaning.

3 In 2011 and 2012, a reform effect arises of SEK 6.5 billion on the pensions area. It is designated in the budget bill as an "assumption for estimation purposes" and is not presented among other suggested or announced reforms, see section 4.2.

Even though the Government considers that the economic development has been stabilised in important ways, the expansionary fiscal policy and weak real economy signify that public finances have been greatly weakened compared to the budget bill a year ago. To maintain confidence in the public finances in this situation, it is of great importance that the monitoring of the budgetary policy targets and the Government's strategy to meet the surplus target is presented comprehensively and clearly. It is in times of crisis that the application of the fiscal framework is put to the test.

The purpose of the audit of the budget bill is to assess how the fiscal framework is applied and how the fiscal policy targets are monitored and presented. A starting point for the audit is the recommendations that the SNAO has presented to the Government in previous reports.[4] Another starting point is the Government's own pledge concerning the application of the fiscal framework.

Chapter 2 discusses the Government's assessment of the long-term sustainability of fiscal policy. Then, the monitoring of the three budgetary policy targets is reviewed in chapters 3-5.In chapter 3, the monitoring of the surplus target is described, with the various indicators that the Government uses. The monitoring of the expenditure ceiling is discussed in chapter 4. Among other things, the way expenditures are presented in relation to the ceiling is treated. Furthermore, the Government's justifications for the expenditure ceiling proposed for 2012 are discussed. The monitoring of the local-governments' finances is audited in light of the Local Government Act's demand for budgetary balance and sound financial management. Certain terminology and concepts used in the report are explained in Annex 2.

4 See Annex 3 for a list of reports that have been published within the audit strategy "Public finances".

2 The sustainability of fiscal policy

Conclusions and recommendations:

The Government's assessment of the sustainability of fiscal policy is based, among other things, on an indicator that gives great importance to deficits far ahead in time.

The Government should review the sustainability analysis and link it to an assessment of the desired level of the surplus target.

2.1 Background

The fundamental motive for the set of fiscal policy rules, which has provided guidance for budgetary and fiscal policy since 1997, is to secure the long-term sustainability of public finances. The experience from the crisis in the beginning of the 1990's is that insufficient confidence in fiscal policy is associated with large costs for both the public and the private sector. The budgetary policy targets aim to minimise the risk that temporary deficits in public finances become permanent and then develop into a debt crisis.

The Government's assessment of fiscal policy sustainability has its point of departure in long-term scenarios for the economy and public finances. The scenarios shed light on, among other things, the challenges that fiscal policy has to face in the coming decades, with a strongly altered age distribution in the population. Corresponding scenarios are presented in the convergence program and provide a foundation for the European Union's (EU) evaluation of the Member States' public finances within the framework of the Stability and Growth Pact.[5]

For many years, the EU has carried out work to develop common principles for the calculations of the public sector's expenditures in the long-term. The latest common expenditure calculations stretch to 2060.[6] Both the presentations of the Government's fiscal policy bills and of the convergence programmes follow a "framework" that greatly builds on these calculation

5 The Convergence Programme is a report to the EU for fiscal policy orientation for the next years in a EU country that stands outside the Monetary Union. Member States within the Monetary Union present Stability Programmes.

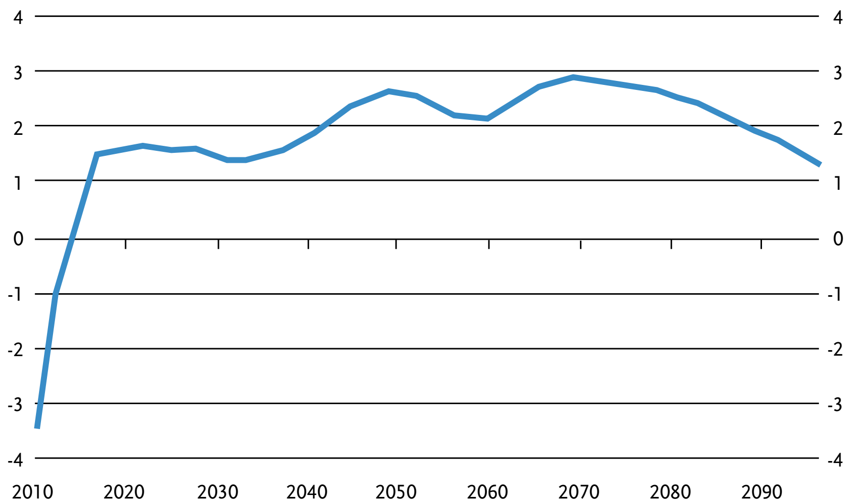
6 Se Ageing report (2009) and Sustainability Report (2009).

principles. In the 2010 budget bill, scenarios for the public finances are designed up to 2099. Besides a baseline scenario, several sensitivity analyses are presented. Calculation methods and models are explained in a separate annex.[7] The presentation has improved in recent years; it is informative and detailed.

However, the presentation is insufficient in one important aspect. The general conclusion of the sustainability analysis is that the orientation of fiscal policy, according to the baseline scenario, is not fully sustainable in the long run. A permanent budget reinforcement corresponding to 0.6 per cent of GDP is necessary. In light of the development of the public finances and the public sector's debts in the long-term scenario, such a conclusion is difficult to understand. Explanations and arguments are all too scarce.

The baseline scenario means that the public finances generate a large surplus during the entire period for the long-term scenario (see figure 2.1). The surplus grows gradually to close to 3 per cent of GDP around 2070 and decreases somewhat thereafter.[8]

Figure 2.1 Net lending in the public sector. Per cent of GDP.

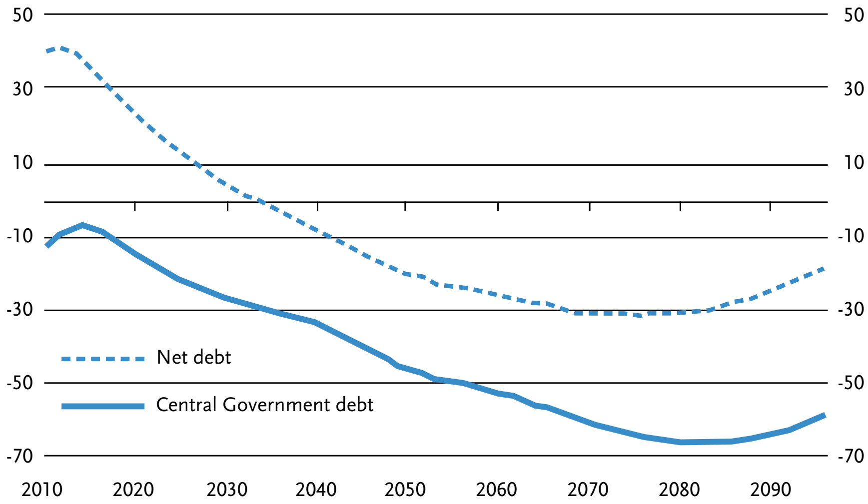


In the beginning of the scenario period, the public sector's net debt is negative, which means that the financial assets exceed the liabilities. Since net lending is positive, the net financial position will gradually be further strengthened. Towards the end of the period, net financial assets amount to 60 per cent of GDP (see figure 2.2). The majority of the financial surplus lies within the central government sector, which means that central government debt will be paid off by around the year 2035 in the baseline scenario.

7 Government bill 2009/10:1 annex 3.

8 Government bill 2009/10:1 diagram 10.9 p. 296.

Figure 2.2 The public sector's indebtedness. Per cent of GDP.



The Government's general assessment is that the fiscal policy's sustainability is relatively good. In the baseline scenario, however, a permanent budget reinforcement of 0.6 per cent of GDP is needed for sustainability, measured with the so-called S2-indicator, to be secured. It is paradoxical that such reinforcement is needed, in spite of the strong development of public finances. The explanation that is given in the bill is that, after 2075, the scenario points toward a decreased public sector surplus. There is no assessment of the reasonableness of the results. Neither is there a presentation of the conclusions when it comes to the orientation of fiscal policy the coming years, in light of the substantial increase of the surplus target which seems necessary in the long run.

In section 2.2, the indicator that the Government uses in the sustainability assessment, the so-called S2-indicator, is described. A division of the indicator into various components that illustrates which factors are behind the Government's sustainability assessment is presented in section 2.3. To demonstrate how the sustainability assessment could be modified, a couple of alternative calculations are presented in section 2.4. In section 2.5, the development of net debt, with alternative assumptions, is presented. Conclusions and recommendations are presented in section 2.6.

2.2 What is the S2-indicator?

2.2.1 *Definition*

The so-called S2-indicator is used both by the Government and by the European Commission to assess the long-term sustainability of fiscal policy. The indicator is applied to the long-term scenarios that are presented in the budget and spring bills. Usually, such a scenario is built on a fiscal policy that has an unchanged orientation starting from a certain year. An unchanged fiscal policy is usually defined so that present tax and transfer rules are fixed during the entire scenario period. Public undertakings like health care, education, child care, geriatric care, etc. are forecasted along with the demographic development. Resources needed per user; for example school children in different ages, are assumed to remain unchanged, which means that public consumption expenditures are solely affected by demographic changes.

The calculation of the S2-indicator is based on the assumption that the public sector's indebtedness cannot grow indefinitely. It has to be restricted sooner or later. With this assumption, a so-called inter-temporal budget constraint can be derived: [9]

$$\sum_{t=t_0+1}^{\infty}(pb_t + S2)/(1+r)^t = d_{t_0} \qquad (1)$$

where

pb = primary balance, i.e. the difference between revenues and expenditures excluding capital income and interest expenditure

S2 = the permanent strengthening of primary surplus required to fulfil the inter-temporal budget constraint

r = discount rate[10]

d = net debt

t_0 = starting year for the sustainability calculation

Equation (1) means that the present value of all future primary surpluses should equal net debt at the starting-point. A positive value for the sustainability indicator S2 signals that the budget requires strengthening in relation to the presupposed fiscal policy in the long-term scenario. Therefore,

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9 See annex 1 for a derivation.

10 See section 2.2.2 below.

this policy is not sustainable. A negative value for S2 signals, instead, that the assumed orientation of fiscal policy allows for a certain amount of unfinanced (permanent) reforms without jeopardising sustainability.

The application of the inter-temporal budget restrictions is problematic in several ways:

– A scenario cannot (of course) include an infinitely long time-period. In the Government's calculation of the sustainability indicator S2, the scenario reaches up to 2099. For the years thereafter, a standard assumption assigns the primary surplus to remain at the end-year level forever. Since savings vary over time, the choice of end-year has a large impact on the value of S2.
– A low discount rate means that surpluses and deficits very far ahead in time weigh heavily in the assessment of sustainability. The choice of discount rate, therefore, plays a large role for the results. This is particularly the case if the primary saving at the end of the scenario period differs from zero and if saving is assumed to remain forever at the same level.

Depending on how both these aspects are handled in the calculation of S2, the assessment of the sustainability can yield very different results. Also, the indicator merely restricts the change of the public sector's net debt. The indicator does not discriminate between different levels of indebtedness. This means that a net debt of 200 per cent of GDP can be described as being as sustainable as a net wealth of 200 per cent of GDP. One can say, therefore, that the S2-indicator is a relatively weak criterion of public financial sustainability, from a fiscal policy point of view.

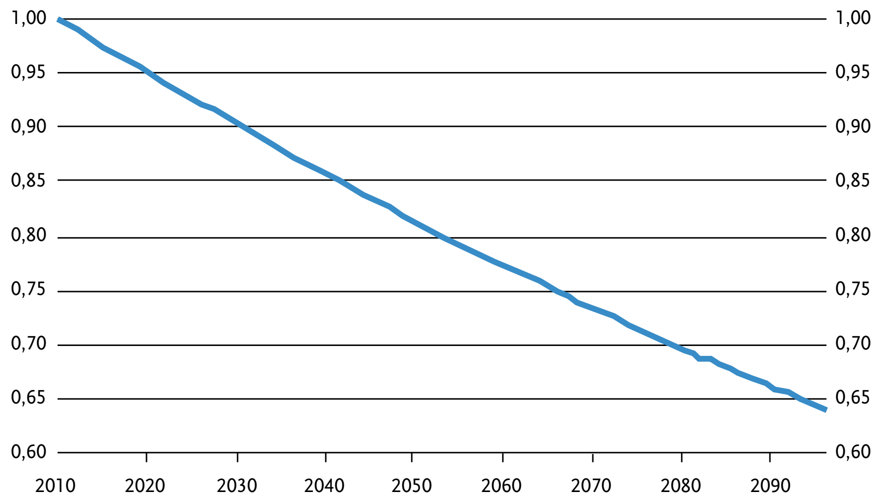
2.2.2 *Discount rate*

Since the variables in formula (1) are given as shares of GDP, the discount rate, *r*, is given by the difference between the nominal interest rate and the growth of GDP in current prices.[11] The Government's calculations use a constant discount rate that is based on the average nominal interest rate (4.9 per cent) and the average growth rate of nominal GDP (4.4 per cent) in the long-term scenario, that is, up to 2099. The discount rate in the inter-temporal budget restriction amounts therefore to 0.5 per cent, which means that a surplus or deficit far ahead in time has a relatively large impact on the sustainability assessment.

[11] Strictly speaking, the discount rate, $r = ((1+R/100)/(1+G/100)-1)*100$ where R is nominal interest rate and G is growth for (nominal) GDP. For "normal" values for R and G, this is about the same as R-G. See Annex 1.

The present value factor $1/(1+r)^t$ indicates the "downward adjustment" (discounting) to the start-year of a future (primary) surplus or deficit which make these comparable to each other. With a discount rate of 0.5, the present value factor $1/(1+r)^t = 1/1{,}005^t \approx 0{,}995^t$, which is relatively large even far off into the future. Figure 2.3 illustrates that public finances, towards the end of the century, are weighed in at about two thirds in today's evaluation of fiscal policy sustainability. A deficit of 1 per cent of GDP 2090 requires a surplus of 0.65 per cent of GDP today to be neutralised.

Figure 2.3 Present value factor with the Government's discount rate.



2.2.3 *Decomposition of S2*

If the primary surplus after 2099 is assumed to remain constant = *pb*, then equation (1) can be written as follows:

$$\sum_{t=t_0+1}^{2099} \frac{pb_t}{(1+r)^t} + \overline{pb} \sum_{t=2100}^{\infty} \frac{1}{(1+r)^t} + S2 * \sum_{t=t_0+1}^{\infty} \frac{1}{(1+r)^t} = d_{t_0} \qquad (2)$$

By using sums of so-called geometric series, this can be rewritten as[12]

$$\sum_{t=t_0+1}^{2099} \frac{pb_t}{(1+r)^t} + \overline{pb} * \frac{1}{(1+r)^{2100-t_0}} * \frac{1}{r} + S2 * \frac{1}{r} = d_{t_0}$$

[12] See annex to chapter 2.

The sustainability indicator S2 can, therefore, be calculated as

$$S2 = r * d_{t_0} - r * \sum_{t=t_0+1}^{2099} \frac{pb_t}{(1+r)^t} - \overline{pb} * \frac{1}{(1+r)^{2100-t_0}} = A + B + C$$

The equation comprises three parts[13]:

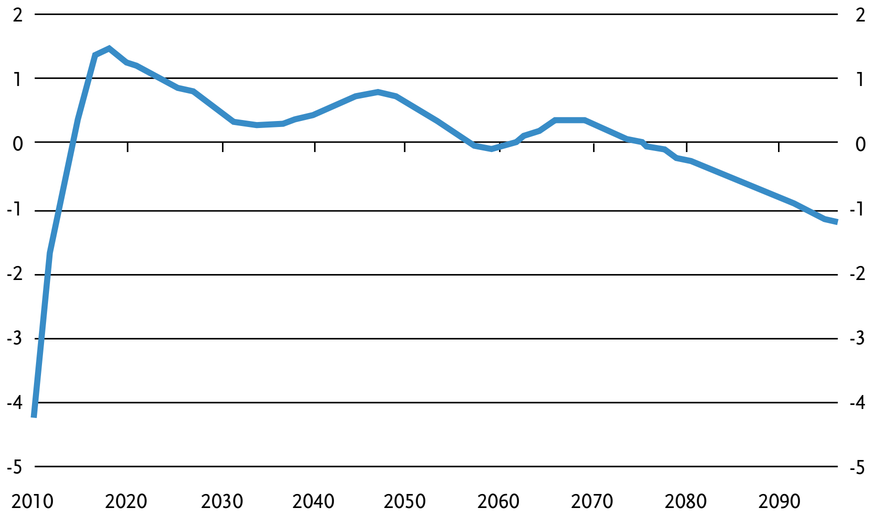
- *"A"* indicates the future (primary) surplus that is required to balance the net debt brought forward from the base-year, i.e., the inherited previous deficits or surpluses. The larger the net debt, the larger the increase of the primary surplus is needed.
- *"B"* stands for the contribution to S2 from primary savings during the scenario period; that is, the period for which public revenues and expenditures are calculated. In the government's calculation, the scenario period spans from 2008 to 2099. The larger the primary surplus, the less additional budget reinforcements are needed.
- *"C"* stands for the contribution to S2 from the period after the last scenario year. The formula shows that the primary net surplus in the end-year is very important for the valuation of sustainability. This is the case especially if the discount factor is small. A primary deficit towards the end of the scenario period is, therefore, of great consequence for the sustainability assessment.

2.3 The components of S2

In the budget bill, the sustainability indicator S2 is calculated to 0.6. It means that a lasting budget reinforcement of 0.6 per cent of GDP is required in relation to the baseline scenario to attain sustainability, namely, so that the inter-temporal budget restriction is complied with. The calculation builds upon a scenario where the primary surplus develops as illustrated in figure 2.4. The scenario entails that the primary surplus is gradually weakened – especially during the period's last two decades. In 2099, which is the end-year in the calculation, the primary deficit has grown to 1.3 per cent of GDP. With the government's method of computation, this deficit is assumed to remain indefinitely.

[13] This dissection is different from that which the Government uses, see Government bill 2009/10:1 Annex 23 p. 9. The Government presents the same division of explanatory factors as the European Commission.

Figure 2.4 Primary saving in the Government's baseline scenario. Per cent of GDP.



A calculation of the different contributions to S2 (A-C) gives the following result.

Table 2.1 The sustainability indicator's components. Per cent of GDP.

S2	+0.6
where A	-0.1
B	-0.1
C	+0.8

Source: SNAO's calculations.

The table shows that the requirement for budget reinforcement, which is presented in the bill, arises exclusively as a result of the primary deficit in 2099. Factor A, which shows the effect of the initial net debt, rather indicates some scope for reform. This is because the public sector shows a positive net financial position at the starting point.

The development of revenues and expenditures up to 2099, factor B, points towards a certain scope for reform as well. When the recession subsides, public finances are expected to show primary surpluses for several decades. Primary deficits do not arise again until the end of the period.

However, the part of the sustainability indicator that represents the period after 2099, factor C, shows a relatively strong need for permanent budget reinforcements. The primary balance is greatly worsened towards the end of the scenario period and the deficit in the end-year is assumed to remain forever. Together with a relatively low discount rate, this fully explains the S2-indicator's positive value, that is, the indication of inadequate sustainability that the Government's calculations provide.

The reason why 2099 has been chosen as the end-year for the long-term calculation is not made clear in the budget bill. Figure 2.4 illustrates that if the end-year for the scenario had been 2070 instead, factor C would have been negative (thus indicating scope for reform), since primary surplus was positive that year. The sustainability indicator's value varies strongly depending on the end-year chosen for the calculation.

2.4 Alternative calculations

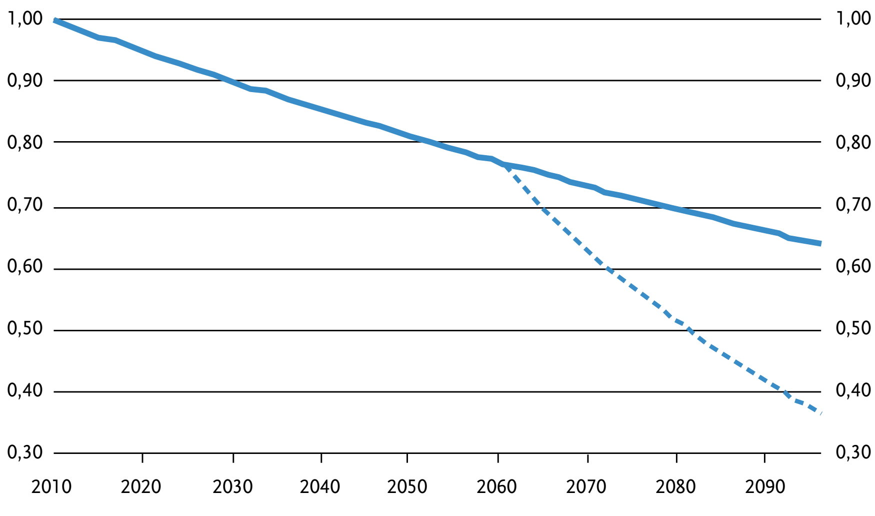
To illustrate the discount factor's importance, a couple of alternative calculations of the sustainability indicator are presented in this section. Both calculations are based on the development of public finances according to the baseline scenario in the budget bill.

2.4.1 Alternative calculation 1

In the first alternative, the discount rate is increased in the later part of the scenario period. A higher discount rate can be motivated by the uncertainties of the long-term and the possibility to deal with an unexpected event with measures later in the period.

Figure 2.5 shows the discount factor if the discount rate is raised from 0.5 per cent to 2.0 per cent starting from 2061. The choice of discount rate is completely mechanical and aims solely at illustrating the S2-indicator's sensitivity to an alternative assumption. A higher discount factor means that revenues and expenditures after 2060 are given less importance for today's decision making. The weight of the primary balance for 2099 is reduced by half compared to the main calculation.

Figure 2.5 Present value factor with an alternative discount rate



The consequences for the sustainability indicator's different components are shown in table 2.2. The sustainability assessment is improved since the modified S2-indicator decreases from 0.6 to 0.1 per cent of GDP. Component A shows the scope for reform that exists when net debt is negative at the starting point. With a discount rate after 2060 that is higher than in the main alternative, the more distant effects of a permanent weakening of the budget will not weigh in as heavily, somewhat widening the room reform.[14] The same effect arises for component B, where the weakening of the budget towards the end of the century does not weigh as heavily in this alternative. The most evident change, however, is that the development after 2099 has less importance for the indicator value, so the need of a budget reinforcement decreases from 0.8 to 0.4 of GDP.

Table 2.2 The sustainability indicator with a higher discount rate after 2060. Per cent of GDP.

S2	+0.1
where A	-0.1
B	-0.2
C	+0.4

Source: SNAO's calculations.

2.4.2 *Alternative calculation 2*

In alternative 2, it is assumed that present fiscal policy management does not take the public financial development after 2099 into account at all. One can say that the discount rate is "infinitely" high starting in 2100. This changes the sustainability assessment further in a positive direction (the S2-indicator's value decreases). First, it is due to the fact that the sustainability indicator by definition is not affected by negative primary balances after 2099.[15] The contribution from this component, by definition, equals zero. Besides, the effects of a weakening of the primary balance are only needed to be taken into account up until 2099. This means that components A and B also contribute for a somewhat larger scope for reform. All in all, a baseline scenario under these conditions is expected to yield a negative S2 value, which signifies that the scenario has some scope for reform.

[14] With two decimals, A = -0.08 in the main alternative and =-0.14 in the alternative with a higher discount rate after 2060.

[15] If the primary balance had been positive in the end-year, then sustainability, measured with the S2 indicator, would have worsened.

Table 2.3 The sustainability indicator with an "infinite" discount rate after 2099. Per cent of GDP.

S2	-0.4
where A	-0.2
B	-0.2
C	0.0

Source: SNAO's calculations.

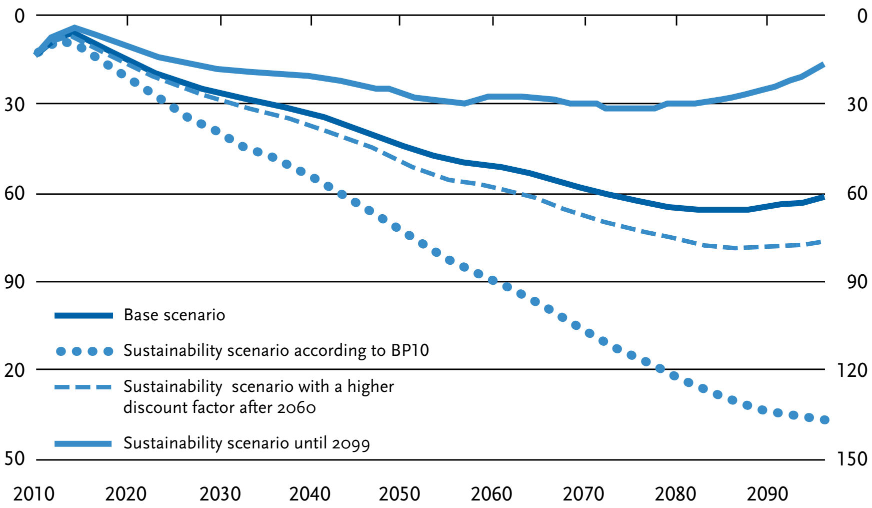
2.5 Net debt

As shown in figure 2.2, the public sector's financial assets in the baseline scenario grow from about 10 per cent of GDP 2010 to 60 per cent 2099. Based on the S2-indicator, the Government concludes that such a development is not fully sustainable. A permanent reinforcement of the primary balance with 0.6 per cent of GDP is considered necessary. Figure 2.6 shows the net debt in the base scenario as well as the debt development that come with the different values for S2 presented above.[16]

With a permanent reinforcement of the primary balance with 0.6 per cent of GDP, net financial assets increase to about 140 per cent of GDP at the end of the period. There is no explanation in the Budget Bill why such a drastic asset accumulation is considered necessary. The bill also lacks a discussion of the consequences for the private sector. Unless the financial assets continuously accumulate abroad due to a current account surplus, the public asset accumulation must be matched by a growing indebtedness in households and firms.

16 The Swedish Fiscal Policy Council has pointed out that total net assets, including real assets like real estate, roads, etc., is a more relevant measure of the public sector's situation than merely the financial assets. Since the Government's sustainability presentation is based on net lending, there is no information on the real wealth in the Government's sustainability calculation. An alternative would be to base the calculations on total savings, which include both financial and real savings.

Figure 2.6 The public sector's net debt. Per cent of GDP.



In figure 2.6, there are two more calculations of the asset development. The first case, "higher discount factor after 2060", corresponds to alternative 1 above. The S2-indicator points towards a certain need for budget reinforcements in this case as well, but to a lower degree than in the Government's calculation. The resulting net financial assets rise during practically the entire period, but in 2099 they are significantly lower than with the Government's S2-indicator. By the next turn of the century, net financial assets are expected to amount to about 80 per cent of GDP.

Finally, the figure also shows the consequences for the calculation where the period after 2099 is left out without any importance in the sustainability assessment (alternative 2). S2 is negative under this assumption, which means that there is a certain scope for reform in relation to the baseline scenario. If this scope for reform is used, then minor increases of financial assets are obtained during the first decades and, towards the end, they slowly subside. The 2099 level is about the same as at the beginning of the scenario period, namely, about 10 per cent of GDP.

2.6 Conclusions

The Government's presentation of the long-term development of public finances has improved during the past years and is, in many respects, clear and illustrative. Uncertainties are explained with alternative scenarios. Methods and models are presented in a separate annex. However, in one aspect, the presentation is inadequate and the result is paradoxical. The baseline scenario points towards a continuing trend in public finances with a growing surplus far beyond the present surplus target of 1 per cent, and with a strong development of the public sector's financial wealth situation. In spite of this, the fiscal policy in the baseline scenario is not considered to be fully sustainable, measured with the so-called S2 indicator. The inadequate sustainability is explained with the development after 2075. Furthermore, the effect that a large accumulation of wealth in the public sector can have on other economic sectors is disregarded.

2.7 Recommendations

The Government should review the analysis and presentation of the long-term sustainability of fiscal policy and the interpretation of the so-called S2 indicator. An alternative could be to ignore the projected development of public finances that is very far ahead in time or to give it less weight in the aggregate assessment. The sustainability analysis should also be related to an assessment of the desired level of the surplus target.

3 Monitoring the surplus target

Conclusions and recommendations:

The indicators the Government uses to monitor the surplus target show totally different and, in some cases, very large deviations from the target. It is unclear what role the indicators play for the Government's orientation of fiscal policy in the years ahead.

The ambiguity of the Government's view on the deviations from the surplus target is problematic in a situation where there is a risk that the target is undershot and where a clear strategy should be designed to secure the fulfilment of the target.

The Government should clarify which role the different indicators play for the assessment of the target deviations and for the orientation of fiscal policy the coming years.

Parallel to the ongoing examination of the fiscal framework, the Government should consider alternative formulations for the surplus target that allow for a more precise presentation of the target deviations.

3.1 Background

The surplus target means that the public sector's net lending should amount to 1 per cent of GDP on average over a business cycle. This comprises the main goal for the fiscal and budgetary policy and has been applied since 2000. The target includes the entire public sector; that is, the central-government, the local-government sector and the pensions system.

The target is formulated as an average over a business cycle because public finances are affected by the economic conditions. In a boom, tax revenues increase and expenses for unemployment decrease. The surpluses that arise are, however, temporary and cannot be used for permanent reforms without jeopardising long-term sustainability of fiscal policy. Furthermore, fiscal stimuli in the form of unfinanced reforms under an economic upswing can lead to overheating and inflation. In a similar way, public finances are weakened in a recession. Cutbacks with the intention to strengthen net lending, however, should be avoided since it would worsen the economic downturn. The formulation of the surplus target as an average over a business cycle reduces the risks of a fiscal policy that reinforces economic fluctuations and weakens the long-term sustainability of public finances.

It should be pointed out that the surplus target is formulated as a precise number, 1 per cent of GDP, and not as a lower limit for the surplus. This means that fiscal policy normally should strive to reduce both positive and negative target deviations.[17]

3.2 The Government's presentation

The wording of the surplus target as an average over a business cycle complicates its monitoring. The reason is that it is difficult to decide on both the length of a business cycle as well as where the economy is in the business cycle. Therefore, since the 2008 spring bill, the Government uses three indicators to monitor the target. All three are expressed in per cent of GDP.

The 2000-indicator

Average net lending from 2000.

The 7-year indicator

Average net lending during a seven-year period. The present year is the midpoint in the calculation.[18]

Structural net lending

The net lending adjusted for the effects of the business cycle, measured with the so-called GDP-gap.[19]

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[17] The EU's Stability and Growth Pact contains a limit for public finances in the Member States. The deficit in the public sector's net lending may not exceed 3 per cent of GDP. This is an absolute limit that pertains to each single year. On top of this, every Member State is committed, in the medium term, to keep savings over the deficit limit. For Sweden, this undertaking (called the Medium Term Objective, MTO) is -0.5 per cent of GDP. The Swedish national target of a surplus of 1 per cent is, therefore, much more ambitious than what is required by the EU-membership.

[18] The calculation is built on adjusted net lending where "large one-time effects" are disregarded. The indicator being calculated as a centered average means, for example, that the value for 2009 is calculated as average net lending for the period 2006–2012.

[19] Net lending is adjusted, as in the 7-year indicator, for "large non-recurring effects" and, in addition, for "extraordinary tax revenues from capital gains".

The latest bills also present cyclically-adjusted average indicators. The reason is that the GDP-gap, even when seen over long periods of time, can on average deviate from zero. An average of net lending over a seven-year period that is characterised by abnormally low capacity utilisation in the economy can give a misleading picture of the target achievement. Thus, there are 5 different ways to calculate the deviations from the surplus target, see table 3.1.

Table 3.1 Net lending in the public sector and indicators for its reconciliation with the surplus target. Per cent of GDP.[20]

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Net lending	**3,7**	**1,7**	**-1,4**	**-1,2**	**0,6**	**2,0**	**2,4**	**3,8**	**2,5**	**-2,2**	**-3,4**	**-2,1**	**-1,1**
Average from 2000	3,7	2,7	1,3	0,7	0,7	0,9	1,1	1,5	1,6	1,2	0,8	0,5	0,4
Cyclically adjusted[1]	3,6	2,9	1,5	0,9	0,8	0,8	0,9	1,1	1,2	1,2	1,1	1,1	1,0
7-year indicator				0,9	1,0	1,1	1,0	0,6	0,3	-0,1			
Cyclically adjusted[1]				0,7	0,6	0,6	0,9	1	1,2	1,2			
Strucural balance	2,1	2,1		-0,5	-0,3	0,6	0,5	1,6	2,3	1,4	0,2	0,7	0,6
GDP gap	**0,4**	**-0,9**	**-0,4**	**-0,7**	**1,0**	**1,3**	**2,5**	**2,6**	**0,0**	**-6,4**	**-6,5**	**-5,0**	**-3,0**
Avrage from 2000	0,4	-0,3	-0,3	-0,4	-0,1	0,1	0,5	0,7	0,6	-0,1	-0,6	-1,0	-1,2
7-year average				0,5	0,8	0,9	0,1	-0,8	-1,6	-2,2			

[1] The cyclical adjustment is made by adding the indicator´s value to the GDP gap for the corresponding period multiplied by the elasticity 0.55.

Källor: Statistics Sweden and Ministry of Finance.

The table illustrates that the target indicators give an incoherent picture of target fulfilment. The average indicators point out that the 1 per cent target is not met in the medium term perspective up until 2012, particularly for the 7-year indicator which even shows a small deficit.[21]

If the average-indicators are adjusted for the business cycle (GDP-gap), target compliance is considerably improved.[22] Between 2000 and 2012, the GDP-gap is, on average, -1.2 per cent. This means that the cyclically adjusted average indicator is strengthened by 1.2*0.55≈0.6 per cent of GDP. The average GDP-gap for the period 2006-2012, that is, the period that comprises the 7-year indicator's value for 2009, is even more negative and amounts to -2.3 per cent. The cyclical adjustment increases the indicator's value with 1.3 percentage points, from -0.1 to +1.2 per cent of GDP. According to the cyclically-adjusted 7-year indicator, the surplus target is surpassed with the fiscal policy orientation that the Government presents in the budget bill.

[20] The GDP-gap is given in per cent of potential GDP.

[21] Observe that, with this accounting measure applied, the 7-year indicator's value for 2009 refers to the average net lending (adjusted for large non-recurring effects) for the period 2006-2012.

[22] The adjustment is made with a factor of 0.55. If the GDP-gap is -2 per cent (recession), the market state-adjusted savings (savings in a normal economic conditions) are appraised to be 0.55*2=1.1 per cent higher than the actual savings.

The Government's summarised conclusion is that net lending will lie somewhat below the target for the next few years, but with the reservation "...provided that it does not again turn out that general government net lending is underestimated when the economic situation improves."[23] At the same time, it is pointed out that it can be "...justified to temporarily allow small and limited negative deviations from the surplus target..." to leave room for measures to mitigate the crisis.[24]

3.3 Demands on target monitoring

The SNAO has, in several audit reports, criticised the Government's presentation of the surplus target for being unclear. The criticism is mainly about the different indicators used in the target monitoring showing completely different estimates of the target deviations. In the audit report "The Government's monitoring of the surplus target" the SNAO formulated the following criteria for target monitoring:[25]

- Principles and methods for target monitoring should be relevant and clearly specified.
- Target deviations should be presented clearly and in a uniform way on different monitoring instances.
- Planned target deviations should be motivated for and their consequences should be described in detail.
- A time plan should be given for reverting target deviations.
- A sufficient foundation should be presented so that an independent judgment of compliance to the target is possible.

The Government's presentation has improved in important aspects, partly in line with the SNAO's recommendations. However, it is still unclear how the different target indicators should be interpreted and weighed in. The Swedish Fiscal Policy Council has also criticised the Government's monitoring of the surplus target for being unclear and states that the three indicators illustrate different goals rather than different aspects of the same goal.[26]

[23] Government bill 2009/10:1 p. 61.

[24] Government bill 2009/10:1 p. 62.

[25] SNAO Report, RiR 2006:27.

[26] Swedish Fiscal Policy Council (2009a p. 90).

3.4 The indicators diverge

The purpose of measuring the deviations from the surplus target is partly to monitor and evaluate the fiscal policy and partly to gain understanding on the size of the adjustments of fiscal policy that will be needed to comply with the target. This applies to both the assessment of room for unfinanced reforms as well as the need for restraints.

The target indicators that are used by the Government, however, are not well suited for this, among other reasons because they are based on average calculations over periods of time that vary in length. Depending on which indicator is used, the presented target deviations have different implications for the extent of the measures needed to adjust fiscal policy towards the target.

A small target deviation expressed in per cent of GDP, according to table 3.1, requires a larger adjustment of policy if the deviation is measured with the 2000-indicator than if it is measured with the 7-year indicator. The reason is that the 2000-indicator (starting from 2007) includes more years than the 7-year indicator. The further ahead in time for which the target deviation is indicated, the larger the difference in number of years that are included in the average calculation. If the 2000-indicator shows a negative deviation from the target in 2012 amounting to 0.5 per cent of GDP, then net lending must surpass the target by a total of 6.5 per cent of GDP in the years to come to meet the target again.[27]

Since the period for the average calculation is shorter for the 7-year indicator, a corresponding deviation demands a smaller adjustment.[28]

The easiest way to amend a target deviation is if it is measured with structural net lending. A deviation from the target with 0.5 per cent a certain year demands an equally large adjustment in the fiscal policy.

3.5 The target deviations are not small

To clarify the indicators' different significance for the assessment of fiscal policy, the SNAO calculated, within the2009 spring bill audit, the accumulated target deviations expressed in SEK billions.[29] The calculation showed that the different indicators gave completely different estimates of the target deviations. The SNAO's conclusion was that the indicators provide very limited guidance for the orientation of fiscal and budgetary policy.

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27 An average deviation of 0.5 per cent during 13 years corresponds to 13 * 0.5 = 6.5 per cent.

28 The need for adjustments can vary since both "good" and "bad" years successively can disappear from the average calculation. Mechanically, the deviation can be calculated to 7 * 0.5 = 3.5 per cent.

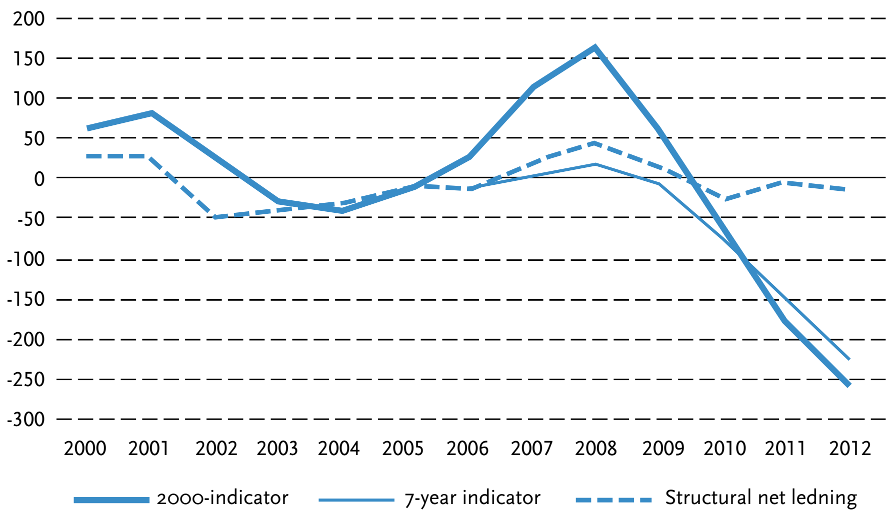
29 SNAO report, RiR 2009:14.

Figure 3.1 shows the accumulated target deviations for average indicators recalculated in SEK billion. Besides this, the presentation of the 7-year indicator, for the sake of clarity, has been moved forward so that the value is presented on the 7-year period's last year instead of the middle year. The value for 2012 applies to the period 2006-2012, while the Government presents the corresponding value for 2009.

The numbers in figure 3.1 show the size of the total net lending adjustment that is necessary sooner or later to reach the target according to each indicator.[30] The figure illustrates that structural net lending is close to the target during the forecast period, while the average indicators show large deviations from the target. In 2012, the accumulated target deviation amounts to minus SEK 220-250 billion. From the formulations in the budget bill, one can instead get the impression that the target deviations during the period up until 2012 are relatively small.

Negative deviations from the target have to be compensated for, sooner or later, with a corresponding surplus exceeding 1 per cent of GDP if the target is to be reached. It can be done through direct saving measures/ tax increases and automatically through a return to normal business cycle conditions. The budget bill lacks a clear presentation of the Government's view on the extent of the need for active measures and on the time perspective during which these measures can be applied without jeopardising economic recovery. Such a presentation is important for the surplus target's credibility even if it continuously has to be revised when forecasts change.

Figure 3.1 Deviations from the surplus target. SEK billion.



[30] Since the 7-year indicator's "memory" only goes 7 years back, fiscal policy can "hang on" during the weak years without needing to compensate for them.

Compared to the spring bill, the deficit in public finances is assessed to be much lower in 2011 and 2012. It also means that the deviations from the surplus target have decreased, even though they are still large when measured with the average indicators. Table 3.2 shows that the under-shooting of the target in 2012, measured with the 2000-indicator, decreased by SEK 90 billion in spite of the proposed reforms. Measured with the 7-year indicator, the improvement is almost as large. Structural net lending in 2012 has, however, deteriorated with about SEK 30 billion, but is still close to the target. From a positive target deviation in 2012 of SEK 13 billion in the spring bill, structural net lending has fallen to a negative target deviation of SEK 15 billion. The target deviation has thus increased, but only with SEK 2 billion.

Table 3.2 The change in net lending and target deviations compared to the 2009 spring bill 2009. SEK billion.

	2009	2010	2011	2012
Net lending	13	9	31	31
2000-indicator	14	-23	-56	-90
7-year indicator (moved forward)	-13	-25	-58	-81
Structural net lending	5	24	2	2

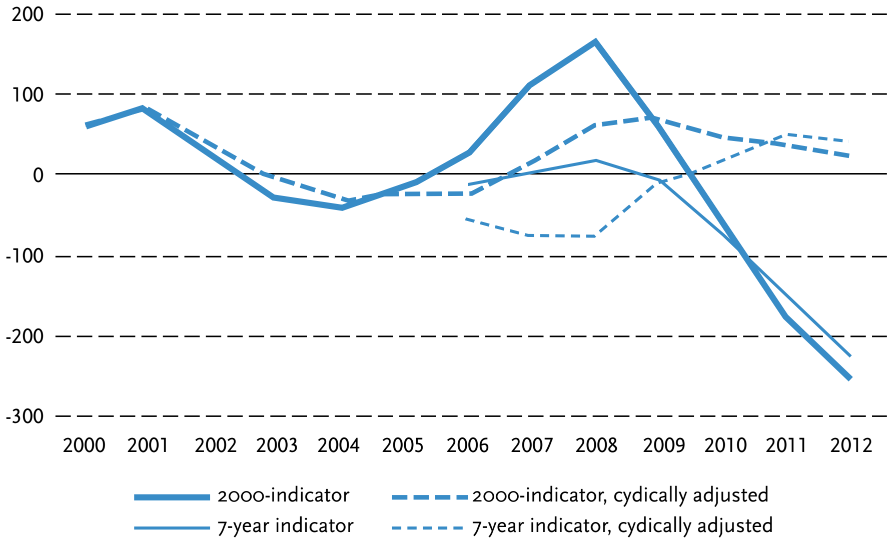
Note: Negative values mean that the target deviations have decreased since the 2009 spring bill and vice versa. In 2009, the target deviation in the spring bill was positive for the 2000-indicator. A higher surplus in 2009 entails that the (positive) target deviation increases. For the 7-year indicator, the target deviation was negative in the spring bill. Stronger net lending, therefore, reduces the target deviation.

Source: SNAO's calculations.

3.6 Unclear use of cyclically-adjusted indicators

For the sake of completeness, figure 3.2 presents the accumulated target deviations for the cyclically-adjusted average indicators as well. These lie comfortably above the target and even point toward some scope for reform. The interpretation can be that a return to normal economic conditions entails that the surplus target is met. The entire target deviation is thus due to the business cycle.

Figure 3.2 Deviations from the surplus target calculated with average indicators. SEK billion.



A problem with relying on the cyclically-adjusted indicators is that the large negative GDP-gap forecasted for the present and the next few years will most likely not be matched by equally large, positive GDP-gaps during the period after 2012. This is also stressed in the budget bill. The GDP-gap is, therefore, assumed not to be symmetric around zero. It is also confirmed by the average GDP-gap for 2000-2012 which, as stated above, amounts to -1.2 per cent. Not even in such a long period of time as 30 years does the Government estimate that the positive and negative GDP-gaps balance out. The data received from the Ministry of Finance shows that the average 1980-2012 GDP-gap is -2.4 per cent. This also means that it can be misleading to use the publicised GDP-gap to assess the situation in relation to the surplus target with cyclically-adjusted (structural) net lending as a starting point. A more adequate picture can be obtained if GDP-gaps for this purpose are determined as the deviation between actual GDP and a trend value that is calculated so that the average deviation from the trend value is zero over a long period of time. Such a method is presented by the National Financial Management Authority in their latest forecast report.[31] The surplus target applies over a business cycle and it should, in this context, be pointed out that a business cycle not necessarily has an average GDP-gap of zero.

[31] "Forecast—the general-government budget and public finances ", ESV 2009:25.

3.7 Conclusions

The Government's monitoring of the surplus target is difficult to interpret. Ultimately, this is due to the present formulation of the target as an average "over a business cycle" which is difficult to handle as long as the meaning of the term *business cycle* is not specified. The indicators that are used to illustrate the target deviations point in completely different directions. Some indicators show very large accumulated deviations from the target, while others show only small deviations. It is not clear what role the indicators play for the Government's orientation of fiscal policy for coming years.

The Government's assessment of the target deviations is especially important in a situation where there is a risk of undershooting the target. An assessment of how much of the target deviation depends on the cyclical position of the economy and how much depends on structural conditions is necessary to design a fiscal policy for the next few years that will meet the target. Uncertainty about future developments means that fiscal policy has to be adjusted gradually and adapted to new circumstances, but this is not a reason to refrain from a clear presentation of the policy orientation.

3.8 Recommendations

The Government should clarify the role that different indicators play for the estimate of deviations from the surplus target and for the orientation of fiscal policy the next few years.

In the current review of the fiscal framework, the Government should consider alternative formulations of the surplus target that allow for a more precise presentation of the target deviations.

4 The expenditure ceiling

Conclusions and recommendations

By bringing forward expenditures with technical accounting measures, the room under the 2010 expenditure ceiling has been increased. Such changes in the expenditure accounting risk harming confidence in the expenditure ceiling and budgetary policy. The Government should, therefore, refrain from such measures.

The motivations for the level of the expenditure ceiling and the ample budgetary margins in 2012 are insufficient in light of the large deviations from the surplus target. The Government should specify how the proposed expenditure ceiling for the third year to come contributes to secure the surplus target.

The principles for budget accounting should be brought up in the ongoing review of the fiscal framework.

4.1 Background

The expenditure ceiling is a central component in the fiscal framework. The expenditure ceiling includes all of the central-government budget's expenditure areas except expenditure area 26 'Interest on the central-government debt, etc.' Expenditures of the old-age pensions system are included.[32]

The expenditure ceiling fulfils two purposes in fiscal policy management:

- First, a ceiling which is decided upon in advance is a clear restriction for the Government's expenditures and forces prioritising between different expenditures when drafting, adopting and implementing the central-government budget. In order for a decided expenditure ceiling to fulfil its purpose, firm principles for the accounting of expenditures are needed. One way to evade an expenditure ceiling is to turn expenditures into tax-account credits. This can be counteracted by a strict accounting on gross basis.[33] Another way to avoid exceeding the ceiling is to bring back or forward payments of subsidies over the turn of a year.

[32] Payments of premium pensions are not included in the ceiling-restricted expenditures.

[33] The past few years, the use of tax-account credits has strongly decreased.

- Second, an expenditure ceiling is an important instrument to meet the surplus target. A decision on a new expenditure ceiling for the third year to come in the medium-term budget forecast means taking a stand on the level of expenditures that can be allowed for if the surplus target is to be met and tax-policy is given the desired orientation. With the weakening of public finances due to the economic crisis, it is especially important that the expenditure ceiling is given a clear connection to the surplus target during the next few years.

Both of these aspects are of great importance for the effectiveness of the expenditure ceiling as an instrument to manage fiscal and budgetary policy. The SNAO has discussed them in earlier audit reports[34], but there are good reasons to continuously follow-up on the Government's handling of the expenditure ceiling.

In section 4.2, the expenditure ceiling and ceiling-restricted expenditures in the budget bill and the spring bill are compared. The presentation of expenditures in relation to prior ceilings is reviewed in section 4.3. The Government's proposal for the 2012 expenditure ceiling is discussed in section 4.4. The SNAO's conclusions and recommendations are presented in sections 4.5 and 4.6.

4.2 Comparison to the spring bill

The budget bill contains a more positive picture of public finances than the spring bill. In spite of relatively large reforms, the deficit is expected to be smaller. For 2011 and 2012, the strengthening of public finances is estimated to SEK 30 billion in spite of reforms of SEK 30 billion.[35] Public finances still show a deficit at the end of the period but the deficit is not expected to be larger than about 1 per cent of GDP.[36]

[34] "The relation between the expenditure ceiling, the surplus target and tax policy ", SNAO report, RiR 2007:22, and "The application of the fiscal framework –the Government's presentation in the 2008 spring fiscal policy bill", SNAO report RiR 2008:15, section 3.3.

[35] The Government's assessment of the public finances for 2011 and 2012 includes an unspecified strengthening of pensions with SEK 6.5 billion each year. This sum is presented, however, not as an effect of a reform in the budget bill but is mentioned on two occasions as a "technical assumption", see Government bill 2009/10:1 pp. 222 and 263. The sum is under "proposed and announced reforms" in table 4.1.

[36] The underlying strengthening of public finances cannot be calculated as the sum of the accounted improvement and the proposed measures, since the measures generate indirect and "dynamic" effects, and their extent cannot be seen in the presentation. The SNAO has, in a previous audit, recommended the Government to include a scenario that is free from additional reforms. In this way, the net effect of the measures could be seen more clearly. See "The Government's presentation of budget effects" SNAO Report, RiR 2007:26. There was no such extra calculation in the budget bill.

Table 4.1 Net lending in the public sector. SEK billion.

	2009	2010	2011	2012
Budget bill for 2009	-68	-107	-67	-36
Spring 2010	-81	-116	-98	-67
Difference	13	9	31	31
Propoced and announced		-32	-30	-29
Presentation in the budget		-32	-24	-22

Source: SNAO's calculations.

In the spring bill, the Government drew the conclusion that "... there is a risk of not reaching the surplus target with a smaller margin than in the forecast years." At the same time, it states that a temporary undershooting was justified due to the deep recession.[37]

In spite of the strong improvement in public finances compared to the spring bill, the Government warns in the budget bill about the risk that the surplus target will not be met this time either. Also, the Government states that further measures could be needed to mitigate the fall in employment, assuming that the measures only generate a limited undershooting of the surplus target.[38] The importance that temporary measures do not become permanent is stressed. The Government emphasises that the measures related to the crisis presuppose a tight expenditure policy for the next few years, but does not exclude future increases of "less harmful taxes".[39] To stress the restrain in expenditure policy, the Government proposes an expenditure ceiling for 2012 that is SEK 10 billion lower than the assessment of the ceiling that was presented in the spring bill.

Table 4.2 shows the revised picture of the expenditure ceiling and the ceiling-restricted expenditures in the budget bill compared to the spring bill. In order for the values to be comparable, both the expenditure ceiling and the ceiling-restricted expenditures have been cleared from the technical adjustments that are presented in the budget bill.

37 Government bill 2008/09:100 p. 50.

38 Government bill 2009/10:1 p. 24.

39 Government bill 2009/10:1 p. 35.

Table 4.2 Expenditure ceiling and budgeting margins. SEK billion.

	2009	2010	2011	2012
2010 Budget				
Expenditure	989	1024	1054	1074
Budgeting margin	14	17	37	49
Ceilling-restricted expenditures	975	1007	1017	1025
Of which Government budget	755	783	786	784
pensions	220	224	231	242
Ditto, exluding technical adjustments				
Expenditure ceiling	991	1020	1050	1070
Budgetary margin	14	17	37	49
Ceilling-restricted expenditures	977	1003	1013	1021
Of which Government budget	757	779	782	779
pensions	220	224	231	242
2009 spring bill				
Expenditure ceiling	991	1020	1050	1080
Budgetary margin	15	15	27	48
Ceilling-restricted expenditures	976	1005	1023	1032
Of which Government budget	756	775	781	775
pensions	221	230	242	257
Adjusted budget bill compared with the spring bill				
Expenditure ceiling	0	0	0	-10
Budgetary margin	-1	2	11	1
Ceilling-restricted expenditures	1	-2	-11	-11
Of which Government budget	1	4	1	4
pensions	-1	-6	-11	-15

The table illustrates that the ceiling-restricted expenditures for 2010 are expected to be somewhat lower than in the spring bill and about SEK 10 billion lower in 2011 and 2012 in spite of the proposed expenditure increases. The lower level of expenditures, however, can be explained entirely by lower pension expenditures which, in turn are due to the Government now calculating the asset-liability ratio correctly. The incorrect calculation of pension expenditures was pointed out in the SNAO's audit of the spring bill, RiR 2009:14, annex 2. A correct calculation decreases pension expenditures with about SEK 20 billion. Furthermore, the Government has included an increase in pensions of SEK 6.5 billion for 2011 and 2012.

The increase in the central-government budget's expenditures in 2010 is limited by the Government entering part of the increased support to the local-government sector as expenditure in the 2009 accounts. (see section 4.3). All in all, the room for expenditures under the ceiling is a couple of SEK billion larger than in the spring bill. In 2011, the room for expenditures is expanded with about SEK 10 billion. For 2012, the proposed downward adjustment of the ceiling with SEK 10 billion means that the budgetary margin remains unchanged compared to the spring bill. As a share of the ceiling-restricted expenditures, it amounts to 4.6 per cent, which is well above the Government's rule of thumb of a margin of at least 3 per cent for the third year to come (see section 4.4).

4.3 Expenditure ceiling and presentation of expenditures

The Government's assessment of the 2010 expenditure ceiling was presented for the first time in the 2007 spring bill. An appropriate level was considered to be SEK 1 033 billion.[40] The budgetary margin was forecasted to SEK 26.5 billion. In the budget bill for 2009, the Government proposed a lower level of the ceiling, SEK 1018 billion, as a result of a series of expenditure accounting adjustments.[41] The budgetary margin is calculated to SEK 33.9 billion, which is 3.4 per cent of the ceiling-restricted expenditures. Since 2007, three large expenditure-items that refer to 2010 have been brought forward, which considerably increases the room for expenditures under the ceiling for 2010:

- In the second supplementary budget for 2007, the Road Administration and the Rail Administration were supplied with SEK 10 billion for early repayment of loans taken from the National Debt Office for investments in infrastructure.[42] The amortisation in 2007 freed, according to the Government's calculations, SEK 1.2 billion per year during the next few years for the Road Administration's and the Rail Administration's investments and consumption.[43]
- In the second supplementary budget for 2008, the Road Administration and the Rail Administration were granted another SEK 25 billion for an early amortisation of loans from the National Debt Office. This time the Road Administration and the Rail Administration appropriations were reduced by about SEK 2 billion per year for the next few years. But since the expenditure ceiling was not adjusted downwards, room for new expenditures was generated.

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40 Government bill 2006/07:100 p. 98.

41 Among other things, the introduction of a local-government real estate charge led to an equal reduction of central-government grants to municipalities, according to the so-called financing principle.

42 In the 2009 budget bill (Government bill 2008/09:1 p. 49), the Government claimed that the early amortisation would increase stability for planning and clarified that state-led investments in infrastructure, as a rule, shall be financed with grants and not with loans.

43 Government bill 2007/08:01 p. 35.

- In the spring supplementary budget and fall supplementary budget in 2009, the Government proposed that SEK 7 and 6 billion, respectively, would be provided to municipalities and county councils in 2010. However, the funds were paid out in 2009, and did not burden the 2010 expenditure ceiling.

The SNAO pointed out in the audit of the 2009 spring bill[44] that bringing forward expenditures has created a larger margin beneath the 2010 expenditure ceiling. If the effect of bringing forward expenditures is added up for the next few budget years, it can be seen that practically the entire budgetary margin that is presented for 2010 has been created through technical accounting measures.

Table 4.3 Effects of expenditures brought forward. SEK billion.

	2007	2008	2009	2010	2011
Bringing forward of Road and Rail Administration´s amortisations	-10,0	1,2	1,2	1,2	1,2
Bringing forward of Road and Rail Administration´s amortisations	0,0	-25,0	2,2	2,1	1,8
Governments grants to municipalities for 2010	0,0	0,0	-13,0	13,0	0,0
Sum	-10,0	-23,8	-9,6	16,3	3,0
Budgetary margin	27,9	13,6	13,7	17,3	26,5
Budgetary margin without bringing forward expenditures	37,9	37,4	23,2	1,0	23,4

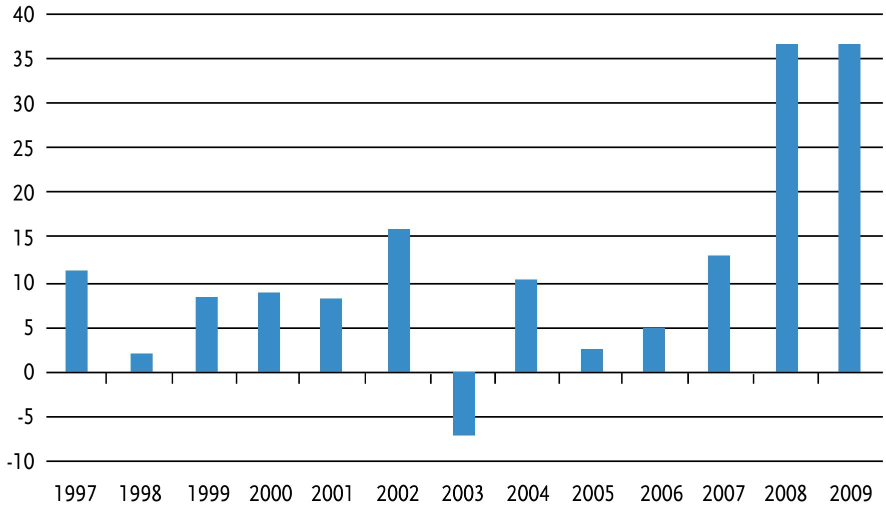
The common feature of these early payments is that they have been proposed in supplementary budgets. The expenditure increases in the supplementary budgets have, therefore, been very large in the past three years, especially in 2008 and 2009 (see figure 4.1).

Due to the strong and unexpected weakening of the economy in 2 008, it is not surprising that the supplementary budgets received increased importance. More than half of these expenditure increases have, however, been used as accounting measures to move ceiling-restricted expenditures between years without making corresponding adjustments of the expenditure ceiling. The Swedish Fiscal Policy Council has raised the subject of the accounting of expenditures in relation to the expenditure ceiling in both their 2009 spring report and in their comment to the budget bill for 2010.[45]

44 SNAO Report, RiR 2009:14.

45 Swedish Fiscal Policy Council (2009a) and Swedish Fiscal Policy Council (2009b)

Figure 4.1 Changes in expenditures on the supplementary budget 1997-2009. SEK billion.



A pre-requisite for the credibility of the expenditure ceiling as a budgetary policy management tool is, according to the SNAO, that the expenditure accounting principles are well designed and clear. The significance of accounting principles when fiscal policy is directed by quantitative targets has been given attention in connection with the EU Stability and Growth Pact.[46]

The SNAO points out that an increased support to the municipalities and county councils in 2010 is consistent with the fiscal policy rules, with a correct accrual accounting of the support. The set of rules does not prohibit making changes in the expenditure ceiling. In fact, the expenditure ceiling is changed in nearly every budget bill due to "technical" reasons. On a couple of occasions, the expenditure ceiling has also been changed for other reasons when the Riksdag and the Government have believed that changes in the economic situation motivated adjusting the ceiling. Instead of the Government's handling of the extra support to local-government with technical accounting measures over the turn of a year, raising the expenditure ceiling would clearly indicate that the expenditure level for 2010 has in fact increased. It is not a question of "breaking" the 2010 ceiling but of clarifying that the expenditure need is larger than what was assumed when the 2010 expenditure ceiling was decided upon in the fall of 2007.

[46] See for example Koen & van den Noord (2005).

4.4 The 2012 expenditure ceiling

In the budget bill for 2008, the Government put forward a number of principles for the assessment of a suitable level for the expenditure ceiling for the third budget year to come:[47]

- The point of departure should be an assessment of net lending in the local-government sector and the old-age pensions system, and the central-government sector's revenues that follow from the preferred tax policy.
- The level should also promote the desired long-term development of central-government expenditures, which means that they should decrease slightly as a percentage of GDP.
- An assessment of the development of the business cycle should be taken into account to avoid unfavourable enhancements of the market fluctuations; that is, pro-cyclical fiscal policy should be avoided.
- There should be a budgetary margin, that is, a difference between the proposed expenditure ceiling and the estimate of the ceiling-restricted expenditures so that forecast uncertainties and temporary variations in the expenditure trends can be handled with given rules. The Government has specified the need for margins of at least 1 per cent of the ceiling-restricted expenditures for the present year (2009), at least 1.5 per cent for year t+1 (2010), at least 2 per cent for year t+2 (2011) and at least 3 per cent for year t+3 (2012).

The SNAO has in previous audits pointed out the lack of concreteness and detail in the application of these principles.[48] Together with the review of the 2009 spring bill, the Riksdag stated that the presentation of the assessment of the expenditure ceiling should be further developed. Among other things, the Riksdag demands a motivation as to why the margin to the 2012 expenditure ceiling surpasses the rule of thumb for the size of the margin that the Government has formulated, especially in a situation where the possibility to reach the surplus target and secure long-term fiscal sustainability risks being questioned. "The Committee considers that it is important that the Government more clearly motivates the proposed level of the expenditure ceiling and conducts a discussion about the trend-wise lowering of the expenditure ceiling. The Committee assumes that the Government will get back to the Riksdag with this information."[49]

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47 Government bill 2007/08:1 p. 77.

48 See for example "The application of the fiscal framework – the Government's presentation in the 2008 fiscal policy bill", SNAO Report, RiR 2008:15.

49 Committee Report. 2008/09:FiU20 p. 82-83.

In the budget bill for 2010, the Government proposes an expenditure ceiling for 2012 of SEK 1 074 billion. The Government states the following as grounds for the proposal:[50]

"The level of the expenditure ceiling for a new year has its point of departure in an aggregate assessment of the set of rules for fiscal policy and the forecasts for the public finances, as well as establishing the expenditure ceiling on a level that is consistent with the surplus target and a long-term, sustainable, fiscal policy. [...] The deficits call for caution in the development of expenditures. A more restrictive expenditure ceiling supports a tight fiscal policy, which supports the return to a surplus in the public finances that is in line with the surplus target. The Government therefore suggests that the expenditure ceiling is set on a level that, excluding technical adjustments, lies SEK 10 billion lower than the assessed level in the 2009 spring economic bill."

The Government also establishes that the suggested expenditure ceiling increases with SEK 20 billion between 2011 and 2012, which is a historically low nominal increase; the level means that the expenditure ceiling as per cent of GDP decreases with 0.5 percentage points on average in 2011 and 2012.[51]

Table 4.2 shows that the Government's proposal for the 2012 expenditure ceiling entails that the budgetary margin, as in the spring bill, amounts to about SEK 50 billion, which equals 4.6 per cent of the ceiling-restricted expenditures. Thus, the budgetary margin in the budget bill too is ample in relation to the rule of thumb (at least 3 per cent of the ceiling-restricted expenditures). The reduction of the expenditure ceiling with SEK 10 billion compared to the assessment in the spring bill is equivalent to the downward adjustment of pension expenditures and can rather be seen as a (partial) correction following an incorrect calculation in the spring bill.

The budget bill lacks a clear motivation as to why the margin is increased in 2011 and maintained at a high level in 2012. Such an analysis had been expected in view of the relatively large deviations from the surplus target (see chapter 3) and the Government's emphasis on the importance of a restrained expenditure policy to secure the long-term stability of the public finances.[52]

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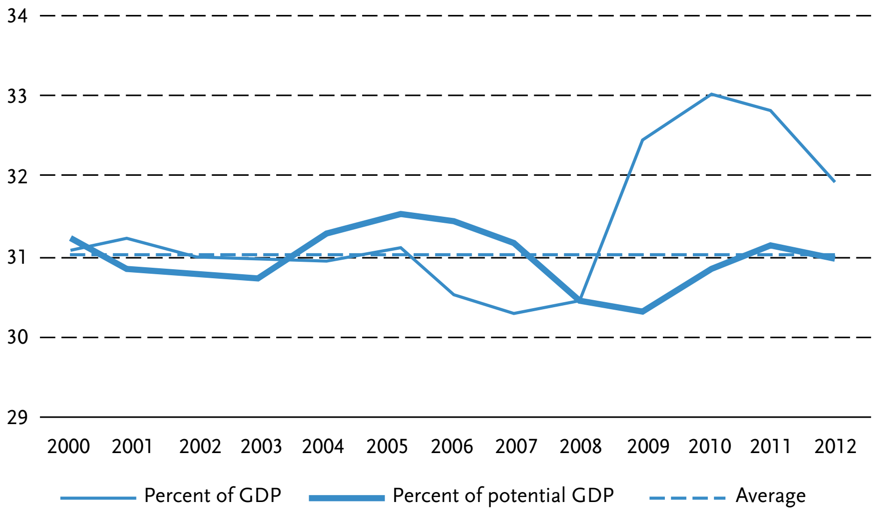
50 Government bill 2009/10:1 p. 100.

51 In 2011, the ceiling as a percentage of GDP decreases with 0.2 percentage points and in 2012, with 0.9 percentage points. The 2012 ceiling has the same percentage of GDP as in 2005.

52 For both 2011 and 2012, the Government's assessments of a suitable budgetary margin for the third year to come (t+3) lies significantly higher than all the years since the expenditure ceiling system was first applied in 1997 put together. The average for previous years is 2.7 per cent of the ceiling-restricted expenditures, while the budgetary margin for t+3 in the past two years has been set to 4.9 and 4.8 per cent of expenditures, respectively.

Figure 4.2 shows the expenditure ceiling as a percentage of GDP and of potential GDP for 2000-2012.[53] The expenditure ceiling as a percentage of GDP increases strongly during the later part of the period because of the weak development of GDP. A more stable measure of the "expenditure ceiling to GDP-ratio" is achieved if the expenditure ceiling is related to potential GDP. The figure shows that 2009-2011 is characterised by a growing expenditure ceiling to GDP-ratio, with a small decrease in 2012 that brings the ratio back to the average for the period 2000-2012. Whether this level is consistent with a restrictive enough expenditure policy to comply with the surplus target and the desired tax policy is not explained in the budget bill.

Figure 4.2 The expenditure ceiling corrected for technical adjustments. Per cent of GDP and potential GDP.



4.5 Conclusions

The expenditure ceiling is the main tool for securing the surplus target and long-term sustainability of fiscal policy. The Government's proposal of the expenditure ceiling for the third year to come should, therefore, be clear and concretely motivated in relation to both the surplus target and the desired tax-policy. However, the Government does not present this information in the proposal for the 2012 expenditure ceiling.

An established expenditure ceiling is essential for the budget process. The ceiling necessitates prioritising between different expenditures in the preparation and implementation of the central-government budget.

53 The expenditure ceiling has been corrected for technical adjustments so that it is comparable over time, see Government bill 2009/10:1 p. 94.

The confidence in the expenditure ceiling is damaged if different types of technical accounting measures are used to evade the ceiling. The payment already in 2009 of the temporary support to local-governments for 2010 is an example.

4.6 Recommendations

The Government should refrain from increasing the room for expenditures through technical accounting measures.

The motivations for the expenditure ceiling and the ample budgetary margin for 2012 are insufficient in view of the large deviations from the surplus target. The Government should specify how the proposal for the expenditure ceiling for the third year to come contributes to meet the surplus target.

The principles for budget accounting should be included in the current fiscal framework review.

5 Monitoring the balance requirement

Conclusions and recommendations

The presentation of the local-government sector's finances is unclear. The differences against the calculation in the 2009 spring bill are, in some cases, significant without any explanation being given. For example, a strong increase in productivity in 2011 is assumed without being further commented on.

The local-government sector as a whole is assumed to comply with the balance requirement but not with the Local Government Act's requirement for sound financial management.

The Government should continue to develop the presentation of the local-government sector's finances, for example, by relating the assessment to both the balance requirement and the requirement for sound financial management. Any gap between the forecast and the Local Government Act's requirement should be clarified. A comparison with the past bill's forecast is a good way to clarify the assessment at hand. Large differences should be commented on.

5.1 Background

The Local Government Act's demand on the financial result in municipalities and county councils is an important part of the fiscal framework. The balance requirement and the requirement for sound financial management decrease the risk of a deficit and contribute to the public sector's compliance with the surplus target.

In the 2009 spring bill, the Government presented a forecast with relatively large deficits in the local-government sector. For both 2009 and 2010, a negative result of about SEK 2-3 billion was predicted. The deficits were estimated to increase to SEK 10 billion in 2012. The rule of thumb that is sometimes used to assess "sound financial management" means that the local-government sector as a whole should yield a surplus of SEK 12-13 billion.[54] Hence, the difference between the forecast in the spring bill and the law's demand was significant. Therefore, in the SNAO's spring bill audit,[55]

[54] The demand is usually considered to equal 2 per cent of the sum of taxes and general grants. See prop.2009/10:1 s 101.

[55] SNAO Report, RiR 2009:14.

the question on the implication of a forecast that conflicts with the balance requirement as well as the requirement for sound financial management is brought up.

5.2 The Government's presentation in the budget bill

The presentation of the local-government sector's finances has improved in the budget bill. It is less fragmented than in the spring bill and it is easier for the reader to gain an overall picture of the forecast. However, the description of the local-government sector's development is still deficient in some aspects.

Table 5.1 shows the forecast for the local-government sector's finances in the budget bill.[56] Revenues increase strongly between 2009 and 2010, especially as a consequence of the increase in central-government grants. Thus, finances are improved in spite of the increase in expenditures. Both net lending and financial outcome improve by SEK 10 billion. The financial outcome is again positive but not strong enough to comply with the requirement for sound financial management, which presupposes a surplus of SEK 12-13 billion.

The local-government sector is calculated to yield a positive result in 2011 as well, in spite of the decrease in central-government grants when the temporary support declines. However, tax revenues grow as the economy recovers and, furthermore, local-governments' expenditures are expected to remain unchanged between 2010 and 2011. In 2012 revenues and expenditures increase almost at the same pace.

Table 5.1 The local-government sector finances according to the budget bill for 2010. SEK billions

						Change from previous years		
	2008	2009	2010	2011	2012	2010	2011	2012
Revenue	731	748	773	772	791	25		19
Taxes	500	511	514	525	542	3	11	17
Central government grants	112	115	137	124	122	22	-13	-2
Other revenues	119	122	122	123	127	0	1	4
Expenditure	728	758	773	772	793	15		21
Consumption	615	635	646	644	660	11	-2	16
Other expenditure	113	123	127	128	133	4	1	5
Net lending	3	-10	0	0	-2	10	0	-2
Financial outcome	8	-6	4	6	3	10	2	-3

Source: SNAO's calculations.

[56] In the corresponding table in the budget bill, table 9.8 p. 276, the local-government real estate charge is presented as a separate item on the revenue side. The real estate charge is, however, already taken into account under "Other revenues", and is thus why the table in the budget bill does not add up.

The difference between the forecasts in the budget bill and the spring bill is shown in table 5.2. A somewhat larger deficit is expected now for 2009. The revised forecast indicates a bit higher tax revenues but expenditures are expected to be much larger. The net lending is SEK 8 billion lower and the financial outcome, SEK 3 billion lower than in the spring bill.

Table 5.2. Local-government sector finances in the budget bill compared to the spring bill. SEK billion.

	2009	2010	2011	2012
Revenue	+5	+17	+9	+10
Taxes	+4	+4	+4	+5
Central government grants	0	+12	+3	+1
Övriga inkomster	+1	+1	+1	+3
Other revenues	+13	+12	-1	+1
Consumption	+7	+8	-4	-3
Other expenditure	+6	+4	+4	+4
Net lending	-8	+5	+9	+9
Financial outcom	-4	+7	+13	+13

Note. The local-government grant for 2010 that was paid out in advance in December, 2009, is presented in the 2009 spring bill in the calculation of net lending. Statistics Sweden has decided that this early payment shall be presented in the year for which it corresponds, which is 2010, in the national accounts. The table's values are based on this accounting principle.

Source: SNAO's calculations.

The period 2010-2012 is characterised by a substantial strengthening of the financial outcome compared to the assessment in the spring bill. In 2010, larger expenditures are balanced by even higher revenues, especially as a result of the further increase of the central-government grants with SEK 10 billion.[57] For 2011 and 2012, expenditures are at the same level as in the spring bill. The somewhat higher central-government grants are explained mainly by the compensation for decreased tax revenues as a result of the increased non-taxable allowance for pension revenues.[58] There is no actual increase of central-government grants in relation to the spring bill included in the calculation for 2011 and 2012.

57 In the 2009 fall supplementary budget, SEK 7 billion is proposed as a temporary support due to the economic conditions. Of these, 1 billion was to lessen the stress on health care due to the influenza pandemic, see the 2009 fall supplementary budget. Government bill 2009/10:2. Additionally, SEK 4 billion for appropriations in 2010 are provided.

58 Besides the compensation for increased non-taxable allowance, the central-government grants increase in 2011 and 2012 as a result of, among other things, higher equalisation grants for operations according to the Act concerning Support and Service for Persons with Certain Functional Impairments (LSS) (1993:387). The increased central-government grants are, however, equalled by the increased fees from the local-governments to the central-government, thus producing no net effect on net lending and the financial outcome for the local-government sector as a whole.

Since the local-government sector expenditures in 2011 and 2012 are expected to be about the same as in the spring bill, the entire increase in revenues is assumed to be used for the reinforcement of local-government finances.[59] The reason why the financial outcome improves more than net lending is that expenditures for investments in municipalities and county councils are assumed to increase. Investment expenditures affect net lending as indicated by the national accounts but not financial outcome as indicated by the local-government accounts.

The budget bill explains that the revenue forecast was revised late in the calculation process and has not been taken fully into account in the expenditure forecast. It is pointed out that consumption volume and employment are, therefore, underestimated for 2011 and 2012.[60] Table 5.1 shows, however, that the presented forecast already indicates that the local-government sector as a whole does not fulfill the requirement of sound financial management neither in 2011 nor in 2012. An additional increase of the expenditure level would widen the gap between the forecast and Local Government Act's requirements. Besides, a certain level of surplus is needed for the sector in total so that the majority of the individual municipalities and county councils are to be considered to follow the balance requirement. An aggregate financial outcome of zero means that a large number of municipalities and county councils do not even make the balance requirement, and much less the requirement for sound financial management. There could hardly be any additional room for expenditure increases within the limits of the presented revenue forecast.

5.3 Local-government consumption and employment

As is shown in table 5.2, expenditures for local-government consumption, that is, operations like schools, health and care services, are assessed to be considerably higher in 2009 and 2010 than in the spring bill. However, consumption expenditures for 2011 and 2012 are expected to be lower. Table 5.3 shows the development of consumption expenditures divided into volume and price according to the budget bill and the spring bill respectively. Seen across the forecast period, 2009-2012, the increase in consumption expenditures is estimated to be lower than in the spring bill. However, consumption volume increases with about ½ per cent both

59 The reason why the financial outcome is strengthened more than net lending is that the investment expenditures in municipalities and county councils are assumed to be higher. Investment expenditures affect net lending in the national accounts. In the local-government accounts, investment expenditures are accounted on an accrual basis. Therefore, the economic result is affected not by the year's investment expenditures but by the writing off of previous investments.

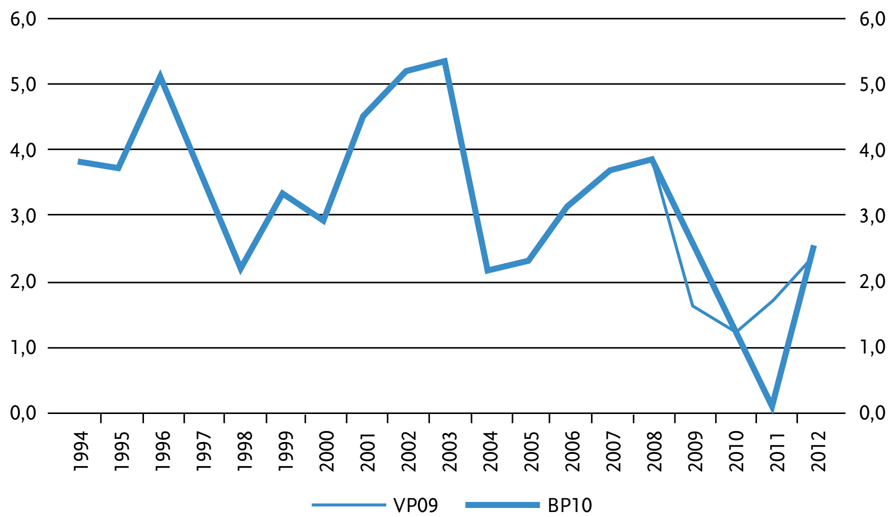
60 Government bill 2009/10:1 s 276.

in the budget bill assessments and in the spring bill. The decrease in the consumption expenditures compared to the spring bill is therefore entirely due to new assumptions on the price development for the local-government consumption. Especially in 2011 the price trend is lower in the budget bill than in the spring bill and also much lower than the historic trend (see figure 5.1). The weak expenditure trend for the local-government operations contributes strongly to the foreseen improvement of net lending and financial outcome.

Table 5.3 The local-government sector's consumption expenditures. Change in per cent.

	2009	2010	2011	2012
Budget bill for 2010				
Consumtion expenditure	3,2	1,8	-0,3	2,4
Consumtion volume	0,5	0,5	-0,3	-0,2
Price	2,7	1,2	0,0	2,6
Cost volume	0,3	0,4	-2,1	-0,8
2009 spring bill				
Consumtion expenditure	2,1	1,6	1,6	2,2
Consumtion volume	0,5	0,3	-0,1	-0,2
Price	1,6	1,2	1,7	2,4
Cost volume	-0,7	0,1	-0,4	-0,2

Figure 5.1 Price index for local-government consumption. Change in per cent.

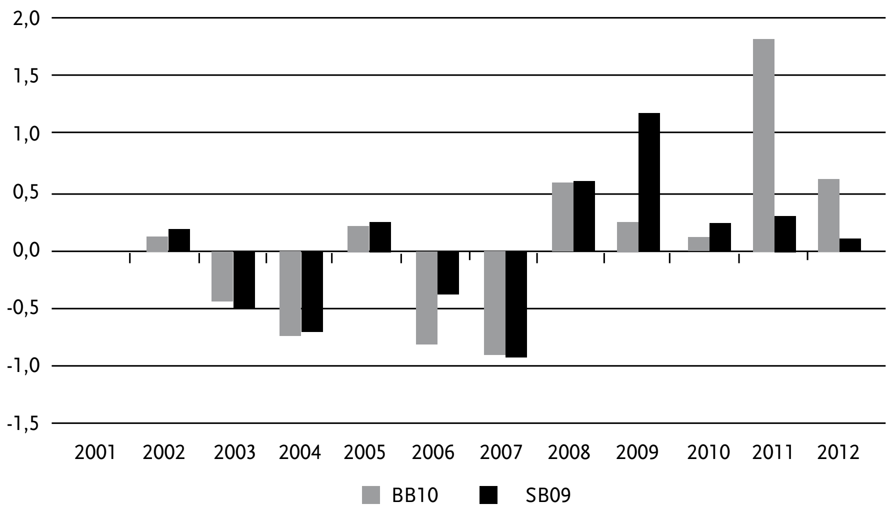


The expenditure development for 2011 is not discussed in the budget bill other than that "the forecasts for 2011 and 2012 are based on municipalities and county councils managing the balance requirement, which means that costs are adapted to revenues."[61] This means that the "cost volume"

[61] Government Bill 2009/10:1 s. 278.

is assumed to decrease substantially in 2011, without affecting the volume of operations. The cost volume reflects the resources spent in local-government operations – mainly in the form of working hours. The forecast means that the volume of operations per hour worked is assumed to increase strongly in 2011 (see figure 5.2). The reason for the change in assessment of the productivity trend in local-government operations is not given. With the same productivity trend in 2011 and 2012 as in the spring bill, the forecast for consumption expenditures in the budget bill would be about SEK 13 billion higher in 2012 than what is presented. In turn, this means that the local-government sector's overall deficit would amount to about SEK 10 billion, that is, the same financial outcome that is presented in the spring bill.

Figure 5.2 Consumption volume per resource input (productivity) in local-government operations. Change in per cent.



Source: Statistics Sweden and SNAO's calculations

An increased productivity in the public sector, as it is measured in the national accounts, means that employee density in the operations is decreasing.[62] The calculation means that fewer employees are needed in the local-government sector compared to the assessment presented in the spring bill to reach the same operation volume. It is foreseen that, between 2008 and 2012, local-government employment will decrease by about 50,000 people. In the spring bill's assessment, the decrease in employment was about 30 000 people.

62 Consumption volume per hour worked can also increase if services are increasingly bought by the private sector. This applies to, for example, private schools and child-care cooperatives.

Table 5.4 Hours worked and employment in the local-government sector. Change in per cent and in numbers, respectively.

	2009	2010	2011	2012	2008-2012
Budget bill for 2010					
Hours worked	-0,9	-0,0	-2,6	-1,0	-4,5
Employed	-21 000	-7 900	-21 900	-900	-51 700
2009 spring bill					
Hours worked	-2,1	-0,1	-0,7	-0,2	-3,1
Employed	-21 600	-7 800	-7 400	9 300	-27 500

5.4 Conclusions

The presentation of local-government finances in the budget bill has improved in several aspects compared to the spring bill. The forecasts are presented integrated in one chapter. It is important that the efforts to increase clarity of the presentation of the forecasts continue. For example, the forecast in the budget bill differs in important aspects from the forecast in the spring bill without any explanation or comment of the causes of the differences. The new forecast implies that the local-government sector as a whole can be assumed to comply with the balance requirement but not with the Local Government Act's requirement of good financial management. This presupposes, however, a strong increase of productivity in local-government operations in 2011. The Government neither comments on nor justifies this assumption, despite the fact that the increase in productivity is a pre-requisite for local-governments to comply with the balance requirement.

5.5 Recommendations

The Government should continue to develop the presentation of local-government finances in the fiscal policy bills by, among other measures, relating the forecasts to both the balance requirement and the requirement of good financial management. Any gaps between the forecasts and the Local Government Act's requirements should be brought up and commented on.

A comparison with the forecasts in the previous bill is a good way to clarify the assessment at hand. Large differences should be explained.

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Annex 1 Derivation of the S2-indicator

The derivation of the inter-temporal budget constraint and the S2-indicator is based on an equation for the development of net debt. In this annex, the relation is shown in greater detail.[63] The following notation is used:

D = net debt

R = nominal interest rate

PB = primary balance; that is, the difference between revenues excluding returns from financial assets and expenditures excluding interest expenditures

Debt equation

$$D_t = D_{t-1} + R_t * D_{t-1} - PB_t = (1 + R_t) * D_{t-1} - PB_t \quad (1)$$

Usually, debt and savings are given relative to GDP. If lower-case letters represent shares of GDP and Y nominal GDP, then the following is obtained from (1):

$$d_t = \frac{D_t}{Y_t} = (1 + R_t) * \frac{Y_{t-1}}{Y_t} * \frac{D_{t-1}}{Y_{t-1}} - \frac{PB_t}{Y_t} = \frac{(1 + R_t)}{(1 + \frac{\Delta Y}{Y_{t-1}})} * \frac{D_{t-1}}{Y_{t-1}} - \frac{PB_t}{Y_t} =$$

$$= (1 + r_t) * d_{t-1} - pb_t$$

where *r* stands for the “difference” between the nominal interest rate and the growth rate for nominal GDP.

If the growth-adjusted rate *r* is assumed to be constant, this can be rewritten in the following way by recursive inserting:

$$d_2 = (1 + r) * d_1 - pb_2 = (1 + r)^2 * d_{t_0} - (1 + r) * pb_1 - pb_2$$

Etc.

$$d_t = (1 + r)^t * d_{t_0} - \sum_{i=t_0+1}^{t} (1 + r)^{t-i} * pb_i$$

63 For a more complete derivation, see *European Economy* no 4/2006, Annex I.

Which can be rewritten as

$$\frac{d_t}{(1+r)^t} = d_{t_0} - \frac{\sum_{i=t_0+1}^{t} (1+r)^{t-i} * pb_i}{(1+r)^t} = d_{t_0} - \sum_{i=t_0+1}^{t} \frac{pb_i}{(1+r)^i} \qquad (2)$$

Equation (2) states that the present value of the future debt at a point in time *t* is equal to the debt at the starting point minus the present value of future primary surpluses.

The inter-temporal budget restriction

The sustainability criterion states that the future debt is not allowed to grow indefinitely. It means that:

$$d_\infty < m$$

for some fixed value of *m*. Since (1+r)>1, one obtains

$$\frac{m}{(1+r)^t} \rightarrow 0 \qquad \textit{when} \qquad t \rightarrow \infty$$

If this condition is applied to the debt equation (2), one gets

$$d_{t_0} - \sum_{i=t_0+1}^{t} \frac{pb_i}{(1+r)^i} = 0 \qquad \textit{when} \qquad t \rightarrow \infty \qquad (3)$$

This equation presents the inter-temporal budget constraint that must be valid in order for fiscal policy to be sustainable in the long-term. It is the starting point for the calculation of the S2-indicator. The indicator shows the permanent change required in relation to a given long-term scenario with the primary saving pb_i in order for the debt development to be sustainable:

$$d_{t_0} - \sum_{i=t_0+1}^{t} \frac{(pb_i + S2)}{(1+r)^i} = 0 \qquad (4)$$

The debt equation (2) also gives a condition for a certain level of debt to be reached by a certain year *T*:

$$d_T = (1+r)^T * \left[d_{t_0} - \sum_{i=t_0+1}^{T} \frac{pb_i}{(1+r)^i} \right] \qquad (5)$$

The European Commission uses this equation to calculate how large a budgetary consolidation is needed to reach a debt level of 60 per cent of GDP a specific year – usually 2050. This is the so-called S1-indicator that is used as a complement to the S2-indicator in the assessment of the Member States' fiscal policy sustainability. It should, however, be observed that the debt level in this case regards the public sector's gross debt, while the debt equation basically describes the development of the net debt. The calculation of S1 must, therefore, be complemented with an assumption on the development of the public sector's financial assets.

Annex 2 Explanations of terminology

Asset–liability ratio

The so-called asset-liability ratio of the public pensions system is calculated as the ratio between total assets and pension liabilities.[64] It is thus a measure of the 'solvency' of the pensions system. If the asset–liability ratio is less than 1, the rules require a reduction in the writing-up of both pensions paid and pension rights earned. This limited index-linking is applied as long as assets are less than liabilities. This balancing mechanism will ensure the financial stability of the pensions system.

The asset-liability ratio is established with a two-year delay since it is based on income as assessed for tax purposes. The weak economic development in 2008–2010 resulted in the activating of the balancing mechanism. This is the first time that this has happened since the reformed pensions system was taken into use ten years ago. The asset-liability ratio is expected to be below 1.0 in 2010–2012, meaning that pensions paid out during these years will have a weaker trend than they would have had with a normal index-linking, unless compensatory measures are taken.

Automatic stabilisers

In a recession, public finances automatically grow weaker as revenues from taxes and charges fall, while expenditures of social-security systems rise. This also means that households' revenues fall less strongly. Income stability, in turn, means that households can maintain their consumption spending, dampening the economic downturn. The opposite is true during a boom. Then, public finances are strengthened, which restricts the increase of household income.

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64 The value of the assets in the form of pension contributions and the balances of the national pension-insurance funds (AP-funds) was estimated at just over SEK 7,000 billion in 2008. The total pension liability is estimated at about the same amount.

Balance requirement

The balance requirement means, according to the Local Government Act (1991:900), that individual local-governments and county councils may not draw up a budget where the costs surpass the revenues. If operations still give a negative financial result, it must be compensated with an equally large surplus within three years. The balance requirement shall be seen as a minimum demand. The Act's demand for "sound financial management" presupposes permanent surpluses.

Budget bill

This budget bill is the Government's proposal for central-government budget for the next budget-year. The budget bill contains, among other things, a budget statement, budgetary policy objectives, appropriation frames for expenditure areas, proposals for appropriations for various purposes and an estimate of the revenues of the central-government.

Ceiling-restricted expenditures

The ceiling-restricted expenditures are the public expenditures covered by the expenditure ceiling. These are all of the central-government budget expenditures except Expenditure Area 26 'Interest on central-government debt, etc.' and including expenditures of the system of old-age pensions. The expenditures of the local-government sector are not included in the ceiling-restricted expenditures.

Central government budget

The central-government budget is a plan for the Government's revenues and expenditures during a budget year. It consists of a revenue side and an expenditure side and several items to calculate the Government's borrowing requirement. The Riksdag adopts the central-government budget and places funds at the Government's disposal for various purposes.

Central-government budget balance= central government borrowing requirement, with the opposite sign

The balance of the central-government budget is defined as the difference between the revenues and expenditures in the central-government budget. A positive budget balance, i.e. a budget surplus, means that the central-government debt decreases. If the balance is negative, there is a budget deficit and, thus, a borrowing requirement, which causes the central-government debt to grow. One difference between central-government net lending (according to the National Accounts) and the budget balance is that revenues and expenditures are reported on an accrual basis in the National Accounts but on a cash basis in the budget balance. Another difference is that the sale of state-owned enterprises affects the budget balance but not net lending.

Discretionary fiscal policy

Discretionary fiscal policy means that the Riksdag and the Government actively change tax rates and/or public expenditures to influence the level of demand in the economy.

Expenditure ceiling for central-government

The ceiling is the maximum permitted level for expenditures in the central-government budget, excluding interest on the central-government debt but including the expenditures of the system of old-age pensions. These expenditures are taken together referred to as 'ceiling-restricted expenditures'. The level of the expenditure ceiling is decided by the Riksdag three years before the budget year to which it applies. The ceiling is nominal, i.e. it is not adjusted for the development of prices and wages between the date of the decision and the year to which the expenditure restriction applies.

Gross debt

The public sector's consolidated gross debt (the 'Maastricht debt') can be calculated as the central-government's debt plus the local-government sector's debts on the credit market minus the national pension (AP) funds' holdings of government securities.

The debt being 'consolidated' means that internal debts between different parts of the public sector have been eliminated. This debt-measure is used in the EU to determine whether Member States comply with the Maastricht Criteria (see below).

Gross domestic product (GDP)

The value of all goods and services produced in a country.

Maastricht criteria

EU Member States may not have a deficit in their public finances that exceeds 3 per cent of GDP. The gross debt should be, at the most, 60 per cent of GDP. See also 'Stability and Growth Pact'.

Medium-term perspective

The fiscal policy bills normally include a forecast of macroeconomic trends and public finances for a three-year period.

National Accounts

A macroeconomic system of accounts for the national economy (production, employment, revenues, expenditures, etc.). Sweden uses the concepts, definitions and classifications of the European System of National Accounts (ESA95). The ESA95 is used in the EU to monitor fiscal policy within the framework of the Stability and Growth Pact.

Net financial assets

Net financial assets = net financial position = financial assets – liabilities = –net debt

Change in net financial assets = net lending + changes in the value of financial assets and liabilities

Positive net lending improves the net financial position. The asset position is also influenced by capital gains/losses on assets; such as, shares or bonds, or on assets/liabilities in foreign currency.

Net lending

The difference between revenues and expenditures, according Statistics Sweden's sector accounts, which are part of the National Accounts.

OECD

The Organisation for Economic Cooperation and Development is a cooperative body for the governments of 30 countries. Its headquarters are in Paris. The OECD is a forum for the exchange of ideas and experiences, and it carries out analytical work in all fields which have an impact on the economies and economic development, above all, of member countries. Key areas of work include macroeconomic development, structural policy and trade policy.

Public sector, general-government sector

Defined in the National Accounts as the sum of the central-government, the local-government sector (municipalities and county councils) and the pensions system.

Potential GDP

Potential GDP is the level of production at normal use of the economy's productive resources. This means that production can be sustained at this level without upward pressure on prices and wages becoming so strong that the Riksbank's inflation target of 2 per cent is exceeded.

Sound financial management

The Local Government Act requires municipalities and county councils to maintain "sound financial management". It means that the financial outcome should be positive and that municipalities and county councils will decide on the targets needed to achieve sound financial management. The act does not provide an exact definition. However, a rule of thumb is that the surplus in a municipality or county council should amount to 2 per cent of the sum of tax revenues and general state grants.

Spring fiscal policy bill

The first stage of the budgetary process. The Government's proposal of guidelines for future economic and budgetary policy.

Statistics Sweden

Statistics Sweden (SCB) is responsible of producing most of the official Swedish statistics.

Stability and Growth Pact

A set of rules to monitor fiscal policy in member states within the framework of the EU cooperation. According to the pact, EU member states are to achieve a level of net lending in the public sector which remains, in the medium term, in the range from -1 per cent of GDP to balance or surplus. However, net lending must (normally) not exhibit a deficit larger than 3 per cent of GDP, and the indebtedness of the public sector must not exceed 60 per cent of GDP.

Structural balance, cyclically-adjusted balance

The structural balance is a measure of what net lending would be in 'normal' economic conditions. Revenues and expenditures are also sometimes adjusted for non-recurring factors other than the effects of the business cycle.

Surplus target

The surplus target is an overall objective of fiscal policy in Sweden. It requires that net lending of the general-government sector corresponds to 1 per cent of GDP on average over a business cycle.

Annex 3 Reports in the public finance audit strategy

RiR 2009:14 *Tillämpningen av det finanspolitiska ramverket. Regeringens redovisning i 2009 års ekonomiska vårproposition* ['The application of the fiscal framework. The Government's presentation in the 2009 spring fiscal bill'] (20 August 2009)

RiR 2009:3 *Skatteuppskov. Regeringens redovisning av bostadsuppskov och pensionssparavdrag* ['Tax deferment: The Government's presentation of deferment of capital-gains tax on home sales and deductions for pension saving'] (17 April 2009)

RiR 2008:30 *Tillämpningen av det finanspolitiska ramverket. Regeringens redovisning i budgetpropositionen för 2009* ['Application of the fiscal framework: The Government's presentation in the 2009 budget bill'] (12 December 2008)

RiR 2008:20 *Granskning av Årsredovisning för staten 2007* ['Audit of the Central-government Annual Report 2007'] (28 October 2008)

RiR 2008:17. *Regeringens hantering av tilläggsbudgeten* ['The Government's handling of supplementary budgets'] (29 September 2008)

RiR 2008:15. *Tillämpningen av det finanspolitiska ramverket. Regeringens redovisning i 2008 års ekonomiska vårproposition* ['Application of the framework of fiscal policy: The Government's presentation in the 2008 fiscal policy bill'] (14 August 2008)

RiR 2007:26. *Regeringens redovisning av budgeteffekter* ['The Government's presentation of budgetary effects'] (22 November 2007)

RiR 2007:22. *Sambandet mellan utgiftstaket, överskottsmålet och skattepolitiken – regeringens redovisning* ['The link between the expenditure ceiling, the surplus target and fiscal policy: The Government's presentations'] (19 November 2007)

RiR 2007:21. *Regeringens analys av finanspolitikens långsiktiga hållbarhet* ['The Government's analysis of the long-term sustainability of fiscal policy'] (17 October 2007)

RiR 2007:16. *Regeringens uppföljning av kommunernas ekonomi* ['The Government's monitoring of the finances of local authorities'] (25 June 2007)

RiR 2007:13. *Granskning av Årsredovisning för staten 2006* ['Audit of the Central-government Annual Report 2006'] (11 June 2007)

RiR 2007:5. *Regeringens skatteprognoser* ['The Government's tax forecasts'] (11 May 2007)

RiR 2007:3. *Regeringens beredning och redovisning av skatteutgifter* ['The Government's preparation and reporting of fiscal expenditure'] (28 March 2007)

RiR 2006:27. *Regeringens uppföljning av överskottsmålet* ['The Government's monitoring of the surplus target'] (6 December 2006)

RiR 2006:23. *Det makroekonomiska underlaget i budgetpropositionerna* ['The macroeconomic data underpinning the Government's budget bills'] (6 November 2006)

For more information on the SNAO, please refer to our website:

www.riksrevisionen.se