Some notes on Fiscal Policy in Sweden

Meeting with French Pension Fund Executives at Grand Hôtel

Stockholm

September 14, 2012

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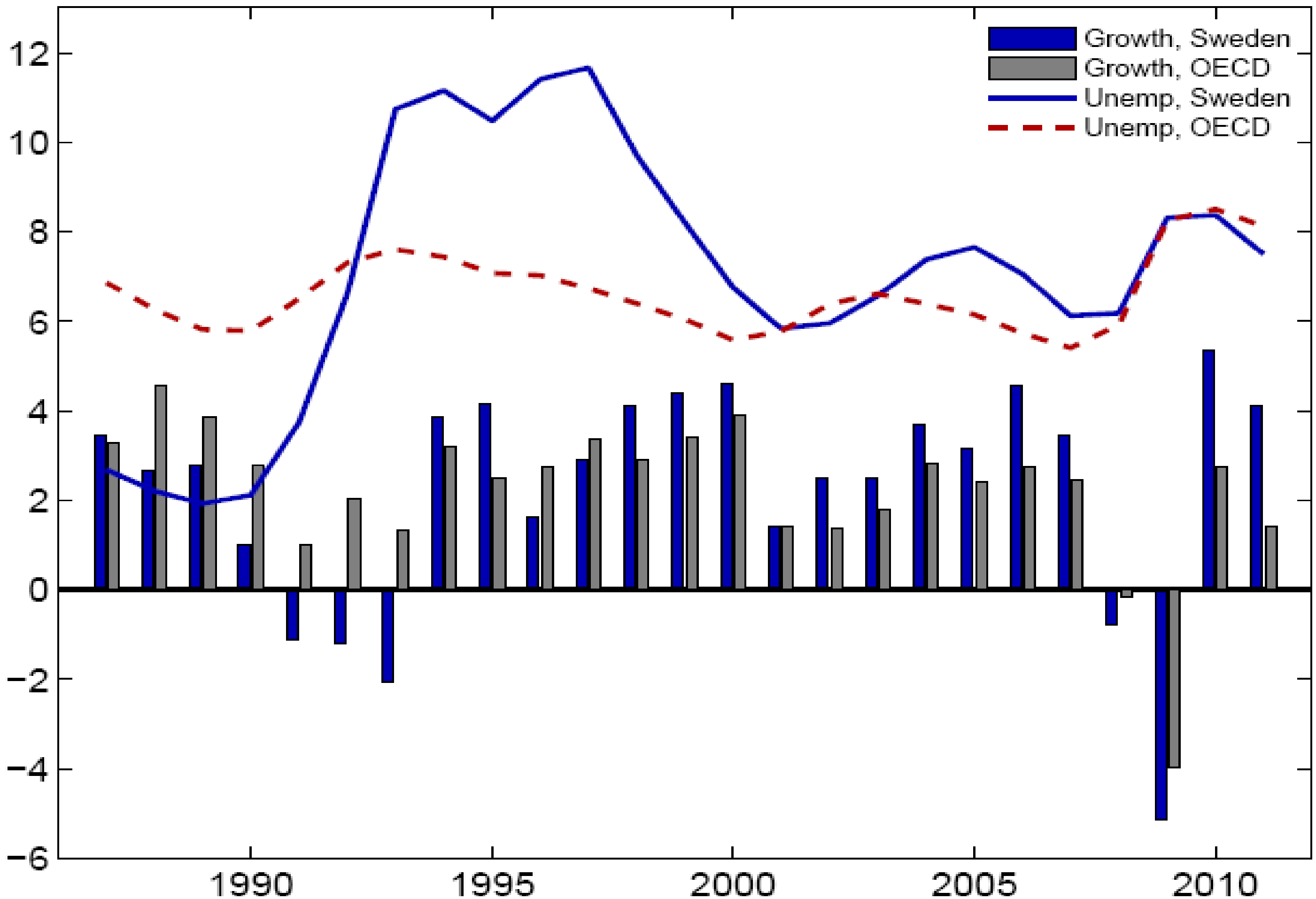
SWEDISH FISCAL POLICY COUNCIL

Sweden during the Recent Crisis

- Despite a 5% drop in GDP in 2009 and a typically high fiscal balance elasticity, Sweden:
  - Moderate drop in the fiscal balance;
  - Modest maximum deficit of 0.7%. Now surplus;
  - Recovered to pre-crisis GDP in 2010.
- Very different from the crisis in the early 1990s: similar amplitude in GDP fall, *but* at that time an extreme deterioration of public finances and rise in unemployment. Long recovery.
- Key explanations for Sweden's good performance:
  - Important reforms were undertaken during the 1990s;
  - No structural imbalances – no domestic amplification mechanisms;
  - Strong budget before crisis due to well-functioning fiscal framework;
  - A conservative Finance Minister determined not to repeat mistakes;
  - Luck…

Growth and Unemployment 1985-2012



Note: Growth rate of GDP (percent) in Sweden and weighted average of 19 OECD countries.

Source: OECD Economic Outlook December 2011.

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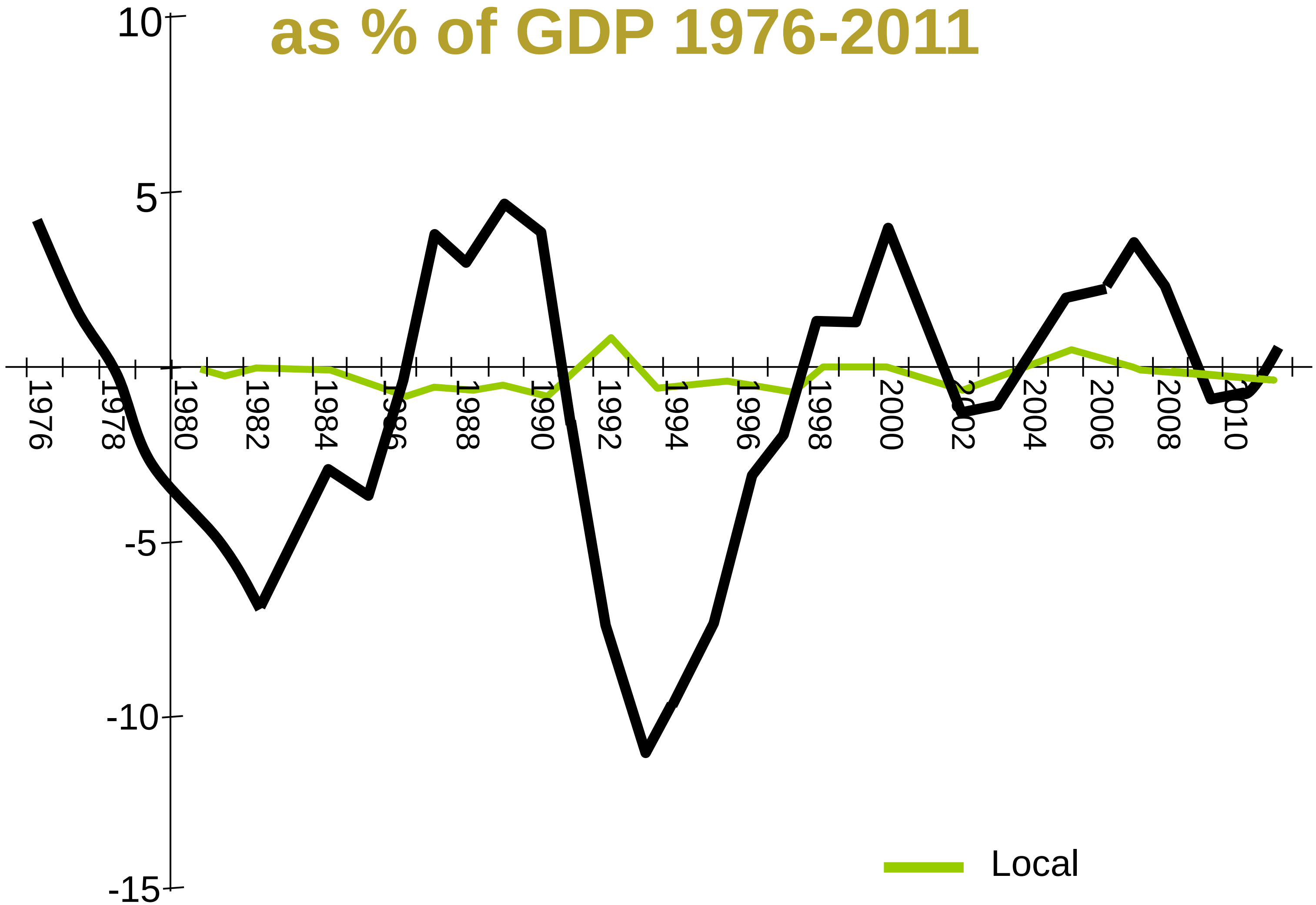
General Government Net Lending as % of GDP 1976-2011



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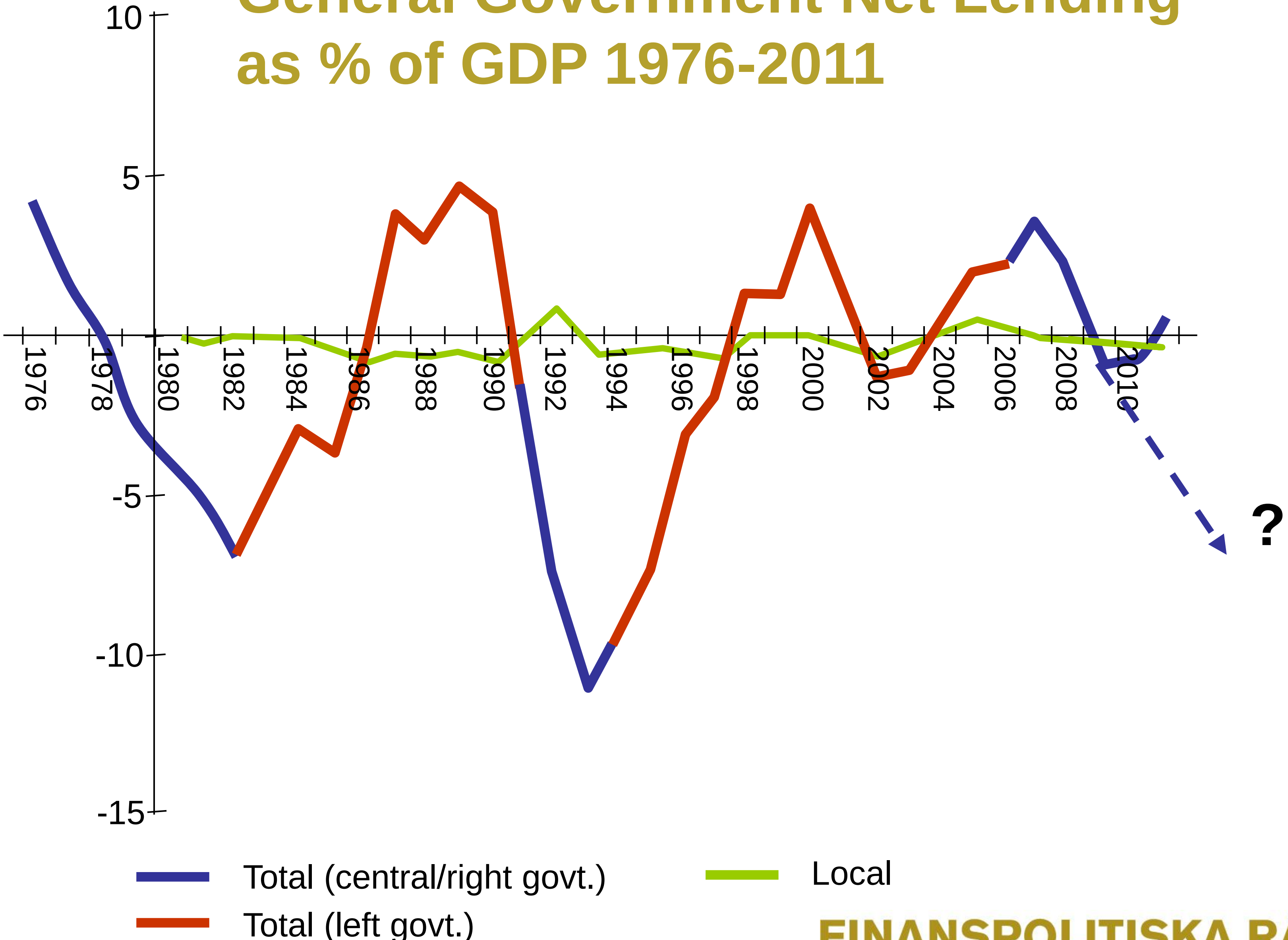

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Background to Reforms

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

A Comprehensive Makeover

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

…A Comprehensive Makeover

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

Lessons from the Crisis in the 1990s

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

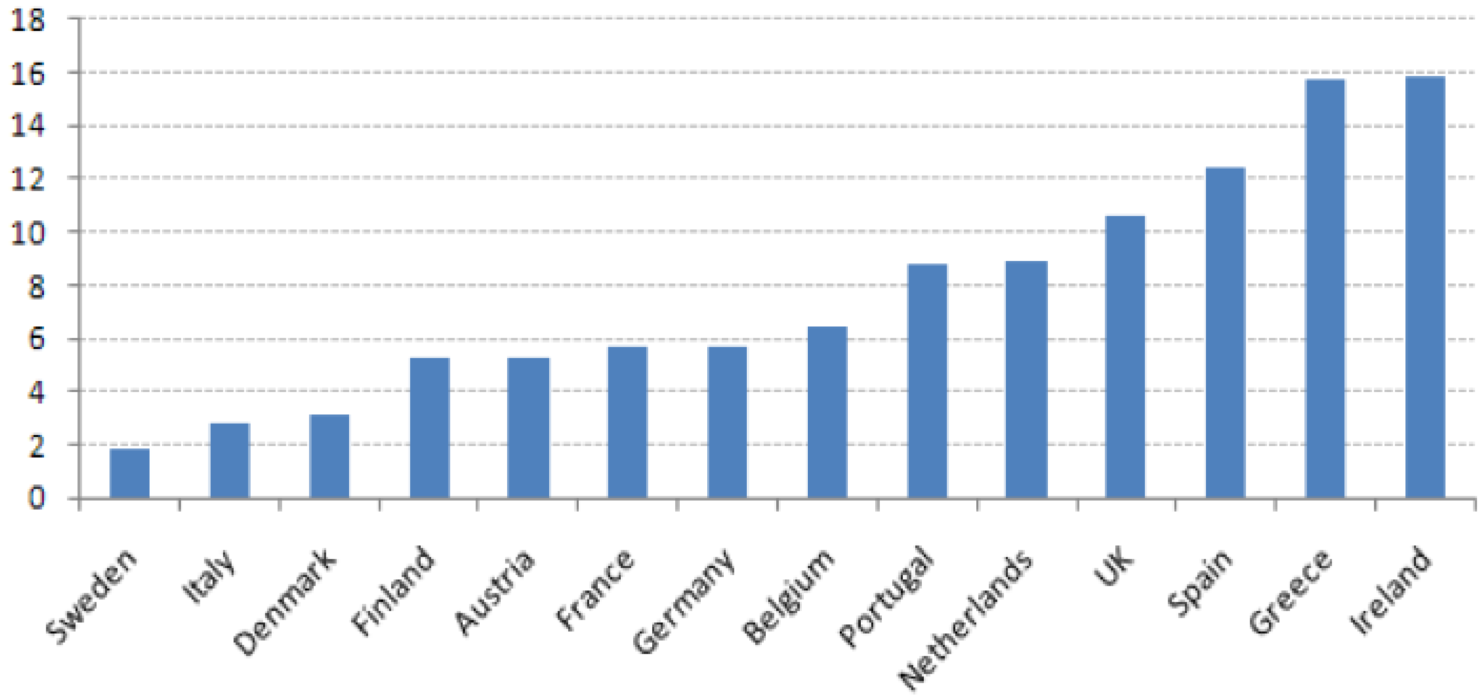
Are the Swedish Experiences Relevant for Current EU Crisis Countries?

- Key differences:
  - Export-led growth through currency depreciation and strong external demand were key components in the Swedish recovery;
  - The substantial consolidation of public finances was implemented after rapid growth had resumed in the Swedish economy (1995-1997);
  - Strict Swedish monetary and fiscal policy implemented around 1995 had contractionary effects on the economy.

The Swedish Fiscal Framework

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

The S2 indicator: European comparison



Note: **The S2 indicator shows the necessary permanent increase in permanent government primary net lending to achieve long-run sustainable public finances.**

Source*:* European Commission (2011) and EEAG (2012).

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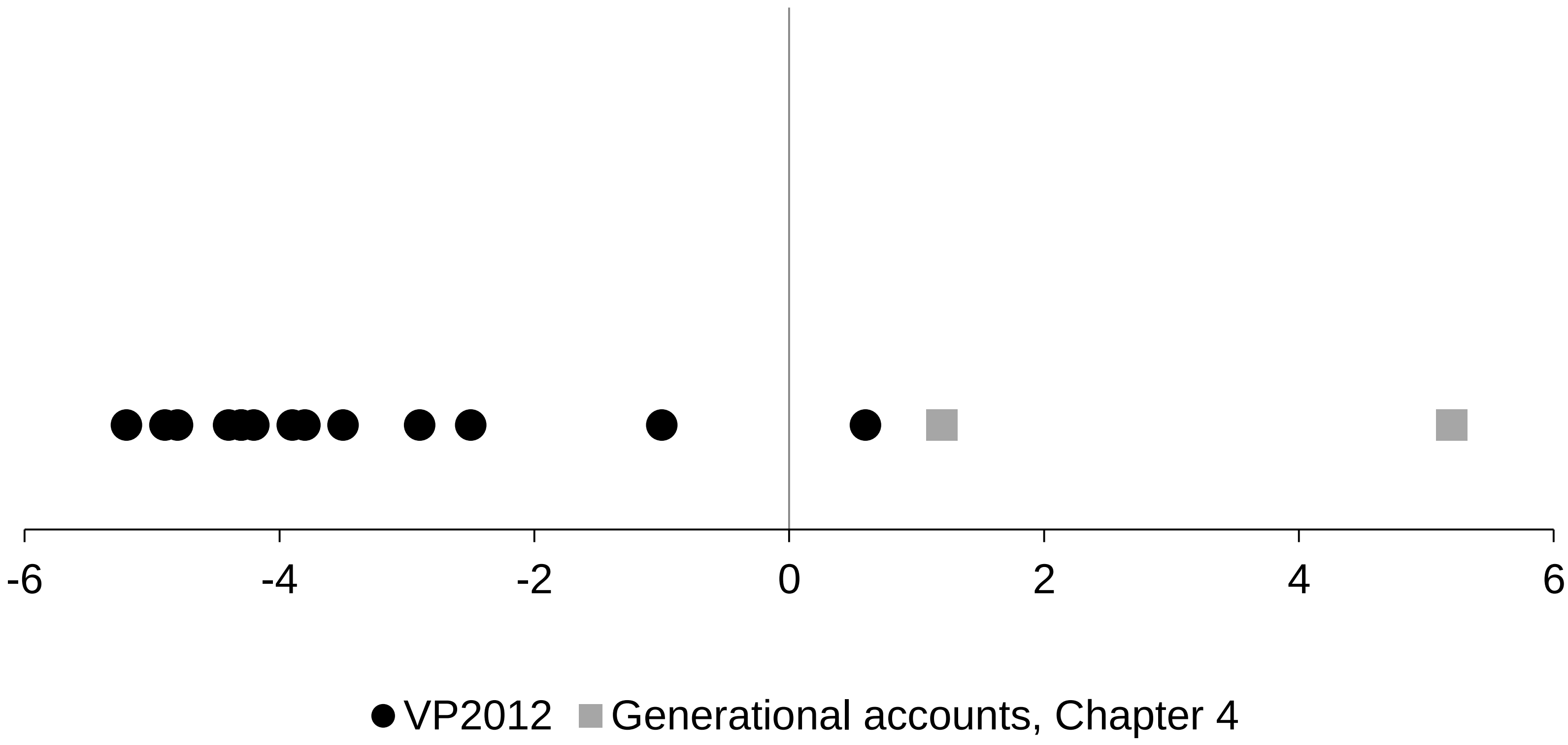
Estimates of Long-Term Fiscal Sustainability

The S2 indicator



Note: Each of the points represents an estimate of the S2 indicator. The estimates are within the range of -5.2 to +5.2. VP2012 is the 2012 Spring Fiscal Policy Bill. The figures for the generational accounts are taken from the background report to Chapter 4 of the Swedish Fiscal Policy 2012 report.

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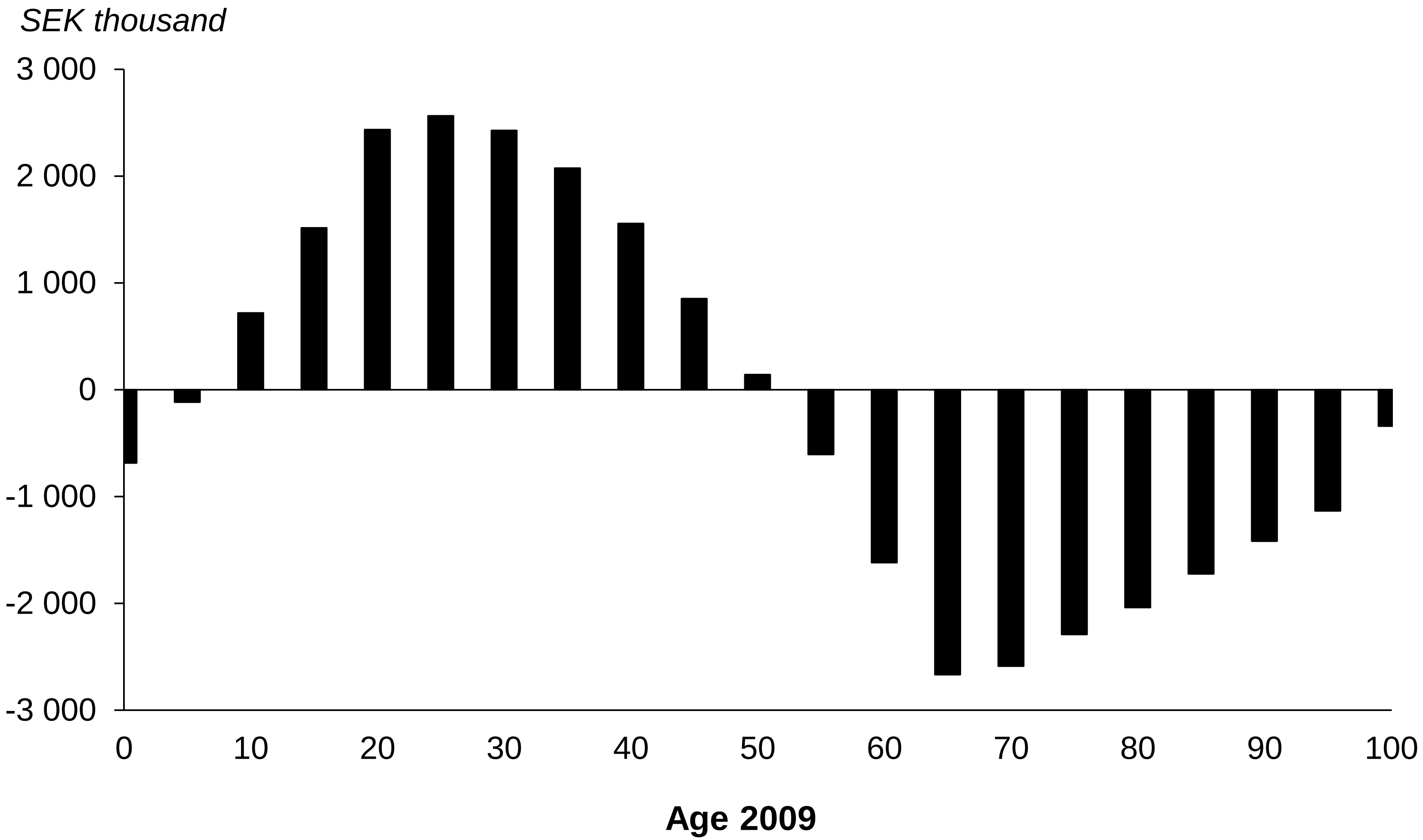
Generational accounts



Source: Hagist and others (2012)

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The tasks of the Fiscal Policy Council

1. Focus on *ex post* evaluation, with some *ex ante* evaluation;
2. Evaluate whether the fiscal policy meets its objectives:
   - Long-run sustainability;
   - Surplus target;
   - The expenditure ceiling;
   - Stabilization issues.
3. Evaluate whether the developments are in line with healthy sustainable growth and a sustainable high employment;
4. Monitor the transparency of the government budget proposals and the motivations for various policy measures;
5. Analyze the effects of fiscal policy on the distribution of welfare;
6. Contribute to a better economic policy discussion in general:
   - Annual report in May (this year May, 14);
   - More information on *www.finanspolitiskaradet.se*.

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