The Swedish Fiscal Policy Council

Erik Höglin and Eva Oscarsson

Meeting with Alon Etkin, Senior Economist, Budget Department, Ministry of Finance, Israel

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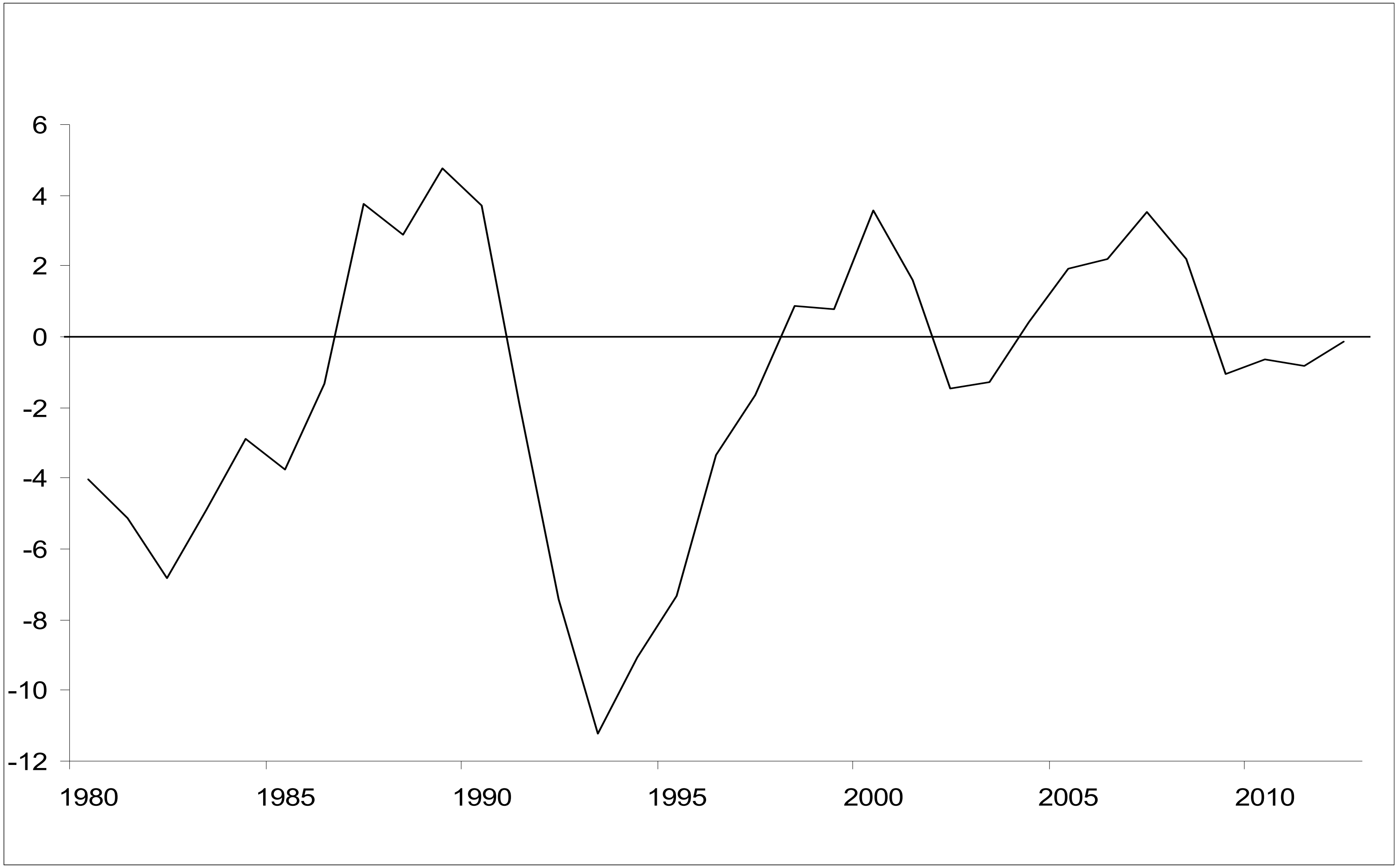
General government net lending in Sweden, per cent of GDP



Source: National Institute for Economic Research.

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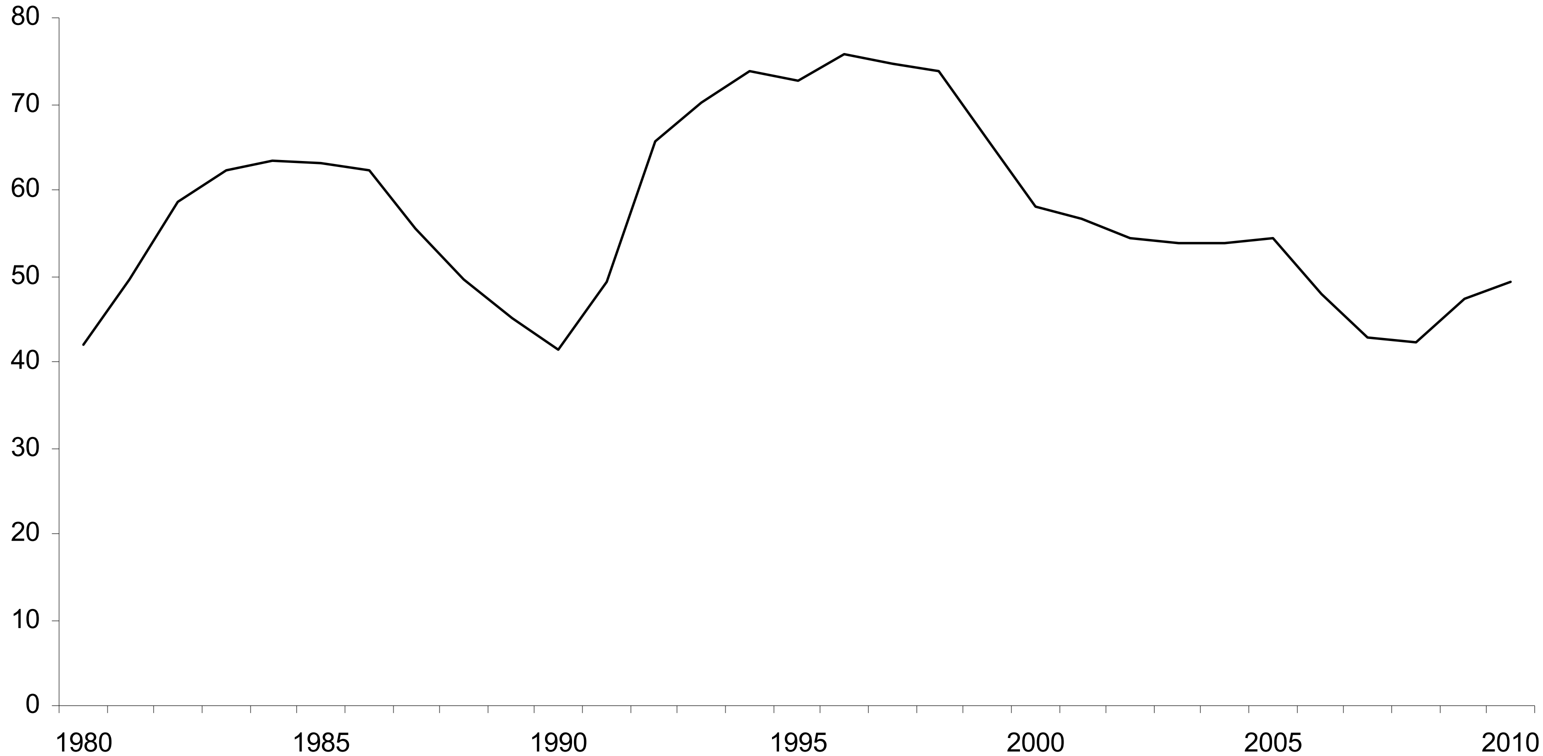

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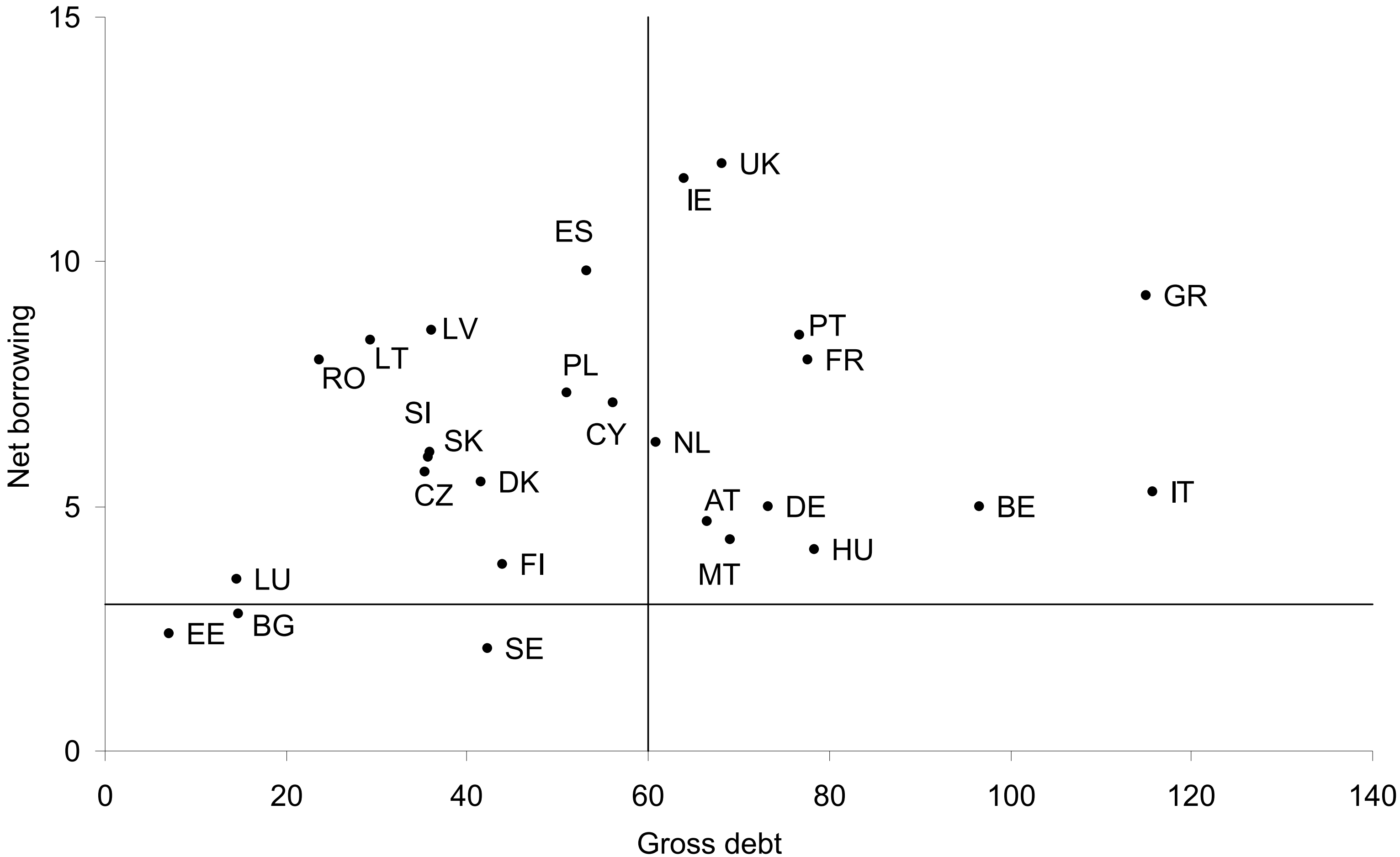
Public finances in the EU 2010 and the rules in the stability pact



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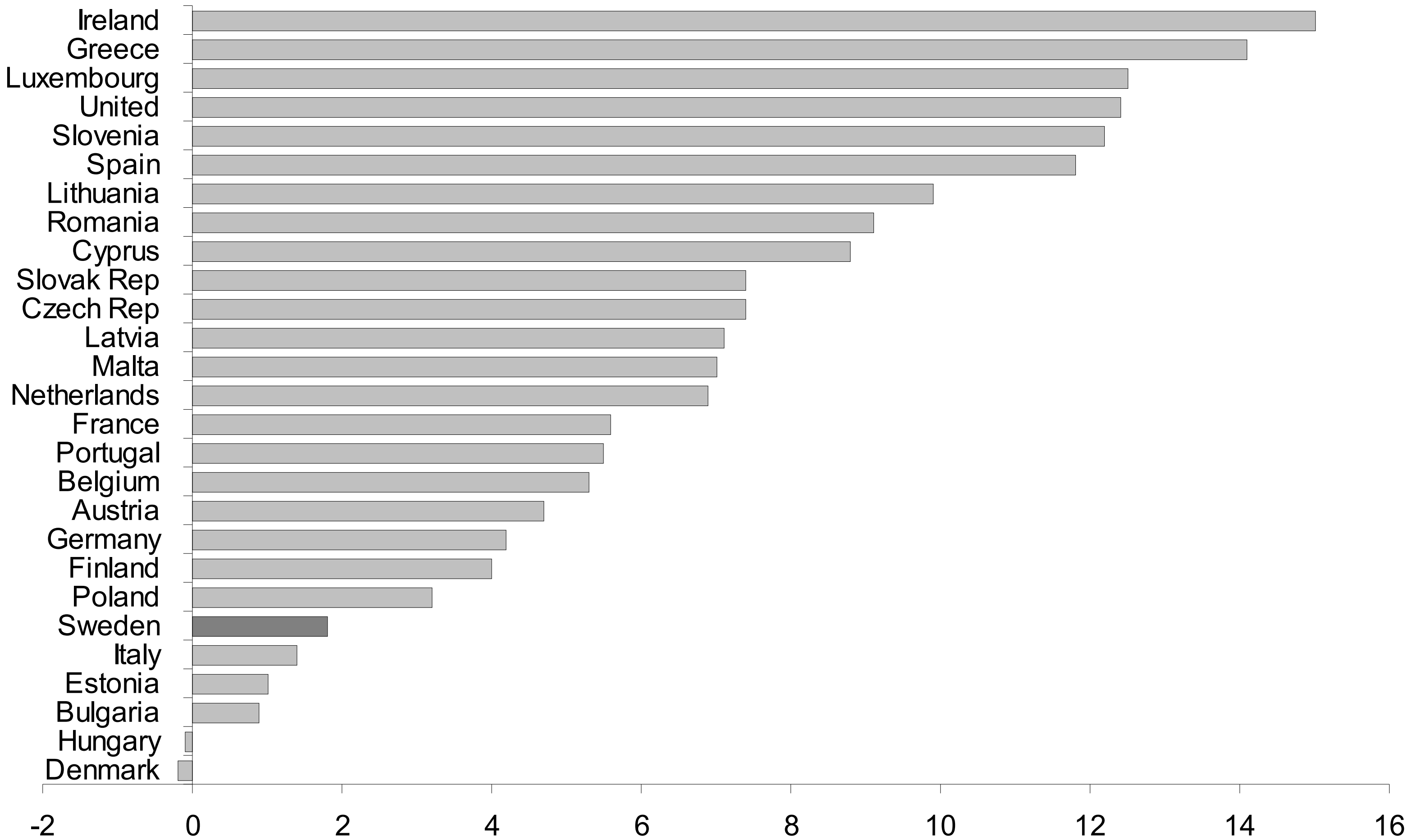
The S2 indicator



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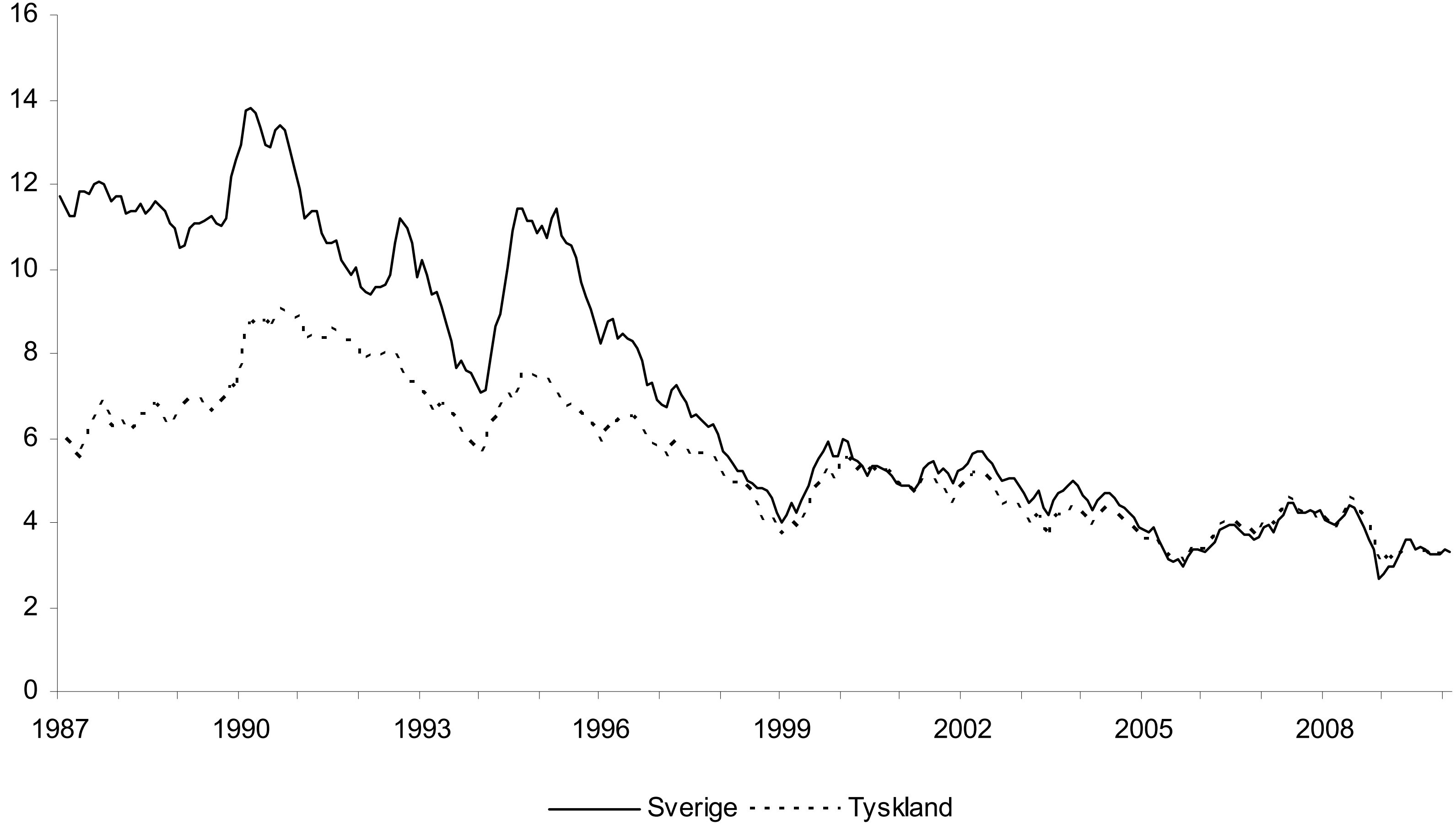
Interest rates on ten-year government bonds in Sweden and Germany



Source: The Riksbank.

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The Swedish fiscal framework

- Top-down approach for the central government budget
- Surplus target for government net lending
- Central government expenditure ceiling
- Balanced budget requirement for local governments
- Fiscal Policy Council

The Budget Process

- Top-down approach (since 1997)
  - Overall expenditures and expenditures in different areas are determined in a first stage in parliament
  - Once this is done individual expenditures are decided
- The Expenditure Ceiling for central government (since 1997)
  - Determined each year by the Riksdag
  - Defines the highest level of expenditure three years ahead
  - Budget margin
  - Problems with tax expenditures and creative accounting

The Budget Process

- The General Government Expenditure Ceiling
  - Equals the Expenditure Ceiling + forecast local government expenditures
- The Local Government Balanced Budget requirement (since 2000)
  - Revenues ≥ expenditures
- The Surplus Target (since 2000)
  - Public finances are required to show a surplus of 1 per cent over the course of a business cycle for the whole public sector
  - Motivation: a buffer for economic fluctuations and demographic changes
- EU Fiscal Rules – Stability and Growth Pact
  - Medium-term objective: close to balance or surplus
  - Deficit ceiling: three per cent of GDP
  - Debt ceiling: 60 per cent of GDP (or decreasing debt ratio)

The council’s background

- Theoretical considerations rather than acute problems
- Government Commission in 2002: requirements on fiscal policy in the event of euro membership
- Positive reactions from the liberal-conservative parties (Anders Borg)
- Negative reactions from the Social Democrats, the Left and the Greens:
  ”another body providing false scientific clothing
  for the government’s right-wing policy”
- Both budget discipline and the fiscal framework are consequences of the fiscal crisis in the 1990s

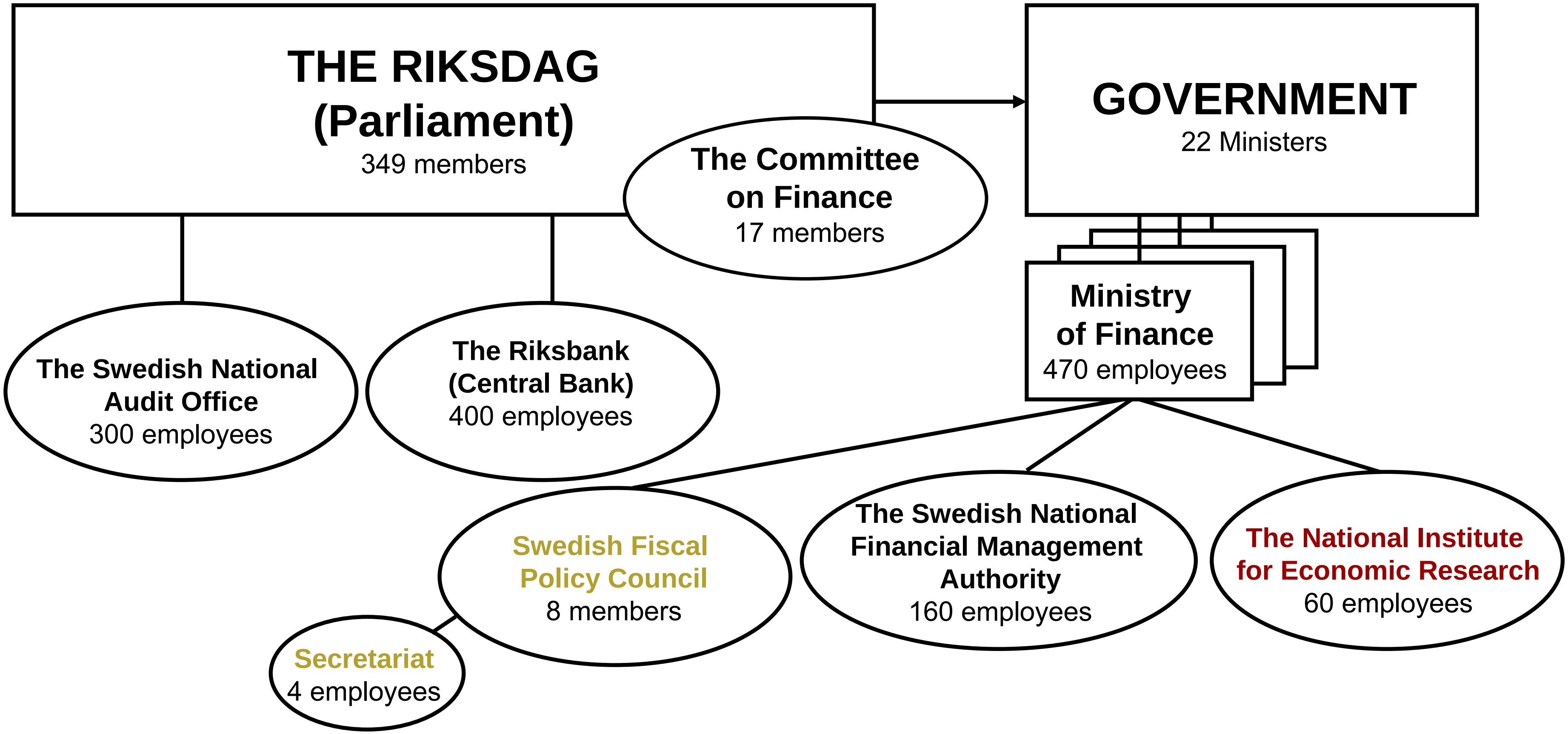
Different approaches to Fiscal Policy Councils

1. Delegation of decisions to independent Fiscal Policy Committee
   - deviation of annual budget target from medium-term budget objective.
   - the use of one or several fiscal policy instruments as stabilisation policy tool.
2. Policy recommendations from independent Fiscal Policy Council.
3. The government should base its budget on the macroeconomic forecasts of an independent Fiscal Policy Council.

Sweden: focus on ex post evaluation, some ex ante evaluation.

The set-up of the council

- Established 2007
- An agency under the government
- Eight members
  - six academics
  - two ex-politicians
- Supplementary activities to ordinary jobs (academic positions)
- Small secretariat: four persons
- Annual budget 700 000 €
- Independence: no informal contacts with the government



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The tasks of the Fiscal Policy Council

1. To evaluate whether fiscal policy meets its objectives:
   - long-run sustainability
   - budget surplus target
   - the expenditure ceiling
   - stabilisation goals
2. To evaluate whether developments are in line with healthy sustainable growth and sustainable high employment
3. To monitor the transparency of the government budget proposals and the motivations for various policy measures.
4. To evaluate the government's economic forecasts and the quality of the models they are based on.

To contribute to a better economic policy discussion in general.

- Annual report: this year 17 May.
- More information on www.finanspolitiskaradet.se

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International trend towards setting up independent fiscal watchdogs

- Sweden 2007
- Canada and Hungary 2008
- Slovenia 2009
- UK 2010 (Office for Budget Responsibility)
- Earlier: Netherlands, Denmark, US, Belgium, Austria
- Discussions: Ireland, Finland, Slovakia, Serbia
- At the European level?

  - proposal from ECB

Themes in the reports

- Increase the clarity of the surplus target: net lending of one percent of GDP over a business cycle
  - underlying fundamental objectives
  - too many indicators
- Criticism of circumventions of expenditure ceiling
- Critical evaluation of fiscal sustainability calculations
- More discretionary fiscal stimulus in the current recession (but less of permanent measures)
- Critical evaluation of the government's labour market reforms
- The economic reporting of the government

The council’s impact

- Extensive media coverage
- Formal response in the spring fiscal policy bill
- Impact on actual policy?
- Impact on actual policy
  - what is the counterfactual?
  - fiscal stimulus in 2010
  - less effect on ”budget tricks”
  - more transparent sustainabililty calculations
  - some effect on surplus target
  - some effect on economic reporting

Challenges for fiscal policy in other OECD countries

- Need for clear and credible exit strategies
- Probably not possible to condition fiscal policy on business cycle developments
- Unconditional strategy: consolidation even if the slump continues
- Consolidations should be rapid
- Fine tuning not an option

Uncertain room for reform in Sweden

- Permanent reforms of SEK 7 000 million in Spring Fiscal Policy Bill
- Uncertainty on the long-run effects of the crisis on the public finances
- Additional promises of unfinanced **permanent** reforms unwise
- Announced reforms may have to be reconsidered
- Some – but not many – additional reforms in both government and opposition election platforms

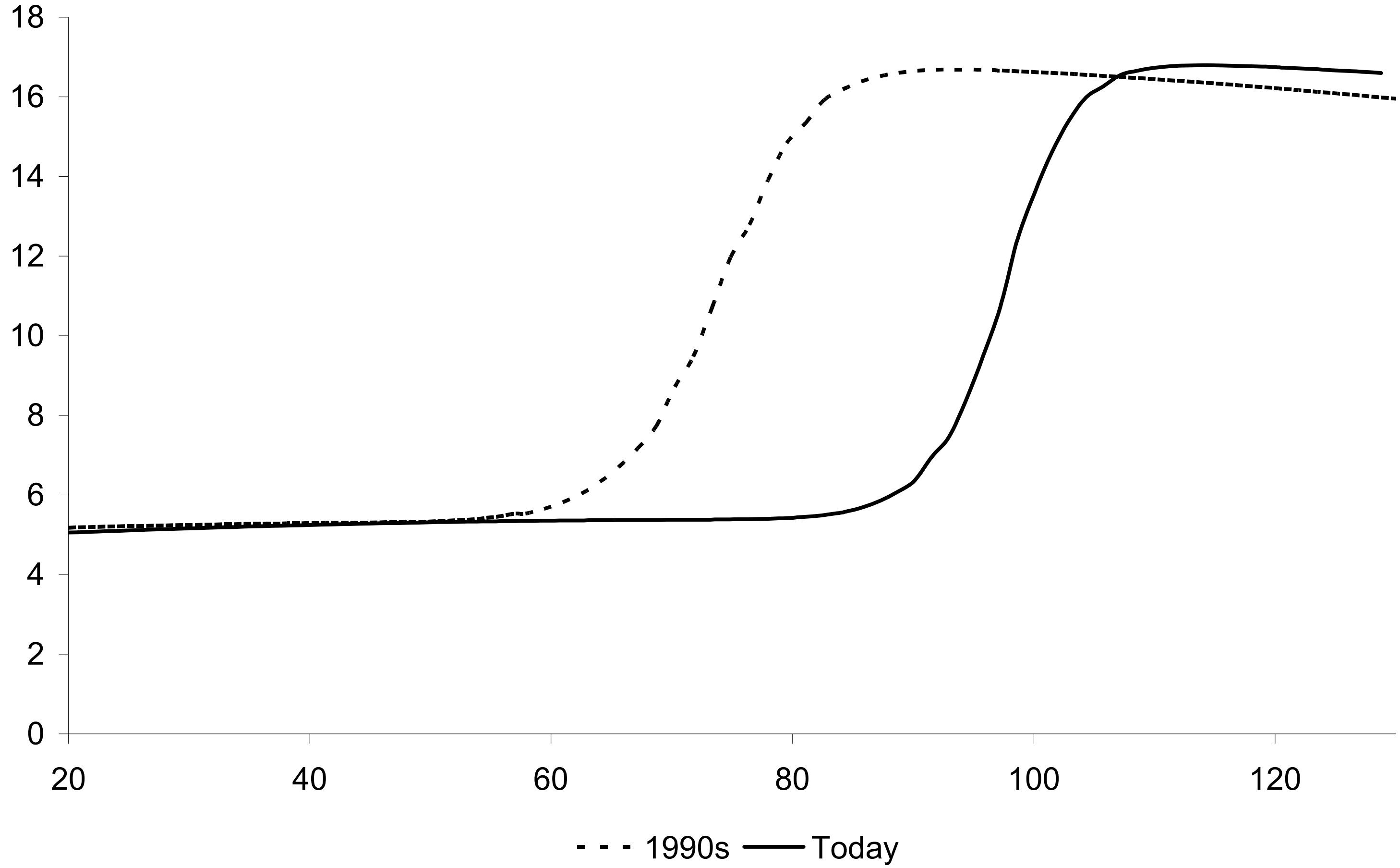
But there is room for manoeuvre in stabilisation policy

- No binding sustainability restriction that prevents **temporary** stimulus measures
- There is a political choice between stabilisation and rapidly restoring public finance buffers for the future
- Extension of extra grants to local governments 2011?

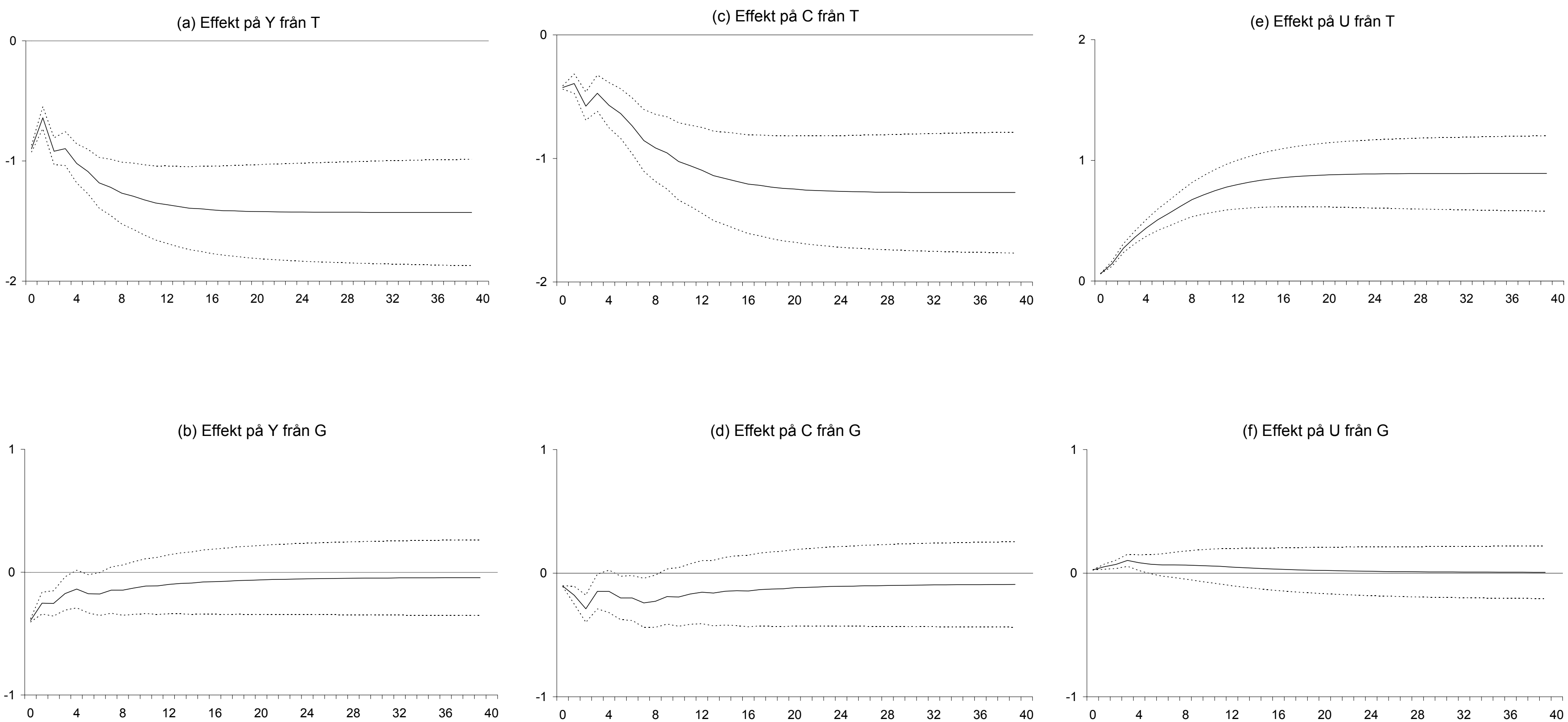
  - could achieve some increase in employment

  - but risk that the grants are perceived as permanent
- Now faster upturn than predicted – probably no need for additional fiscal stimulus
- Need for rules system to smooth local governments' incomes over the business cycle
- The government has acted too slowly in this matter

Public sector debt-to-GDP ratio and interest rate on government debt, 1990s vs today



Effect of higher taxes or lower gov’t spending in “normal” times



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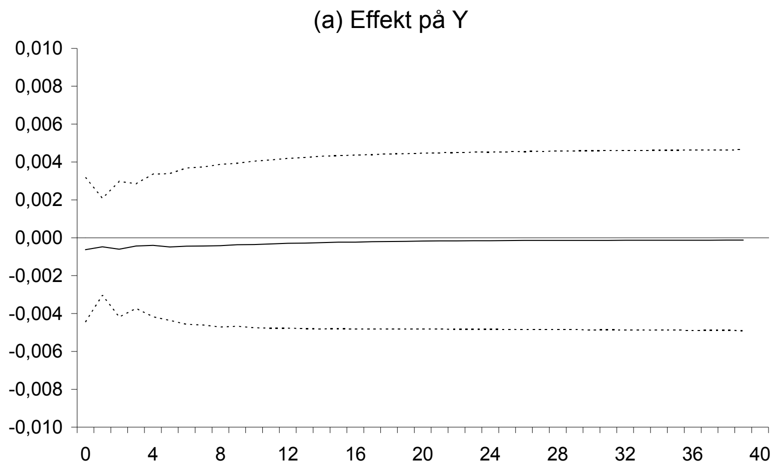
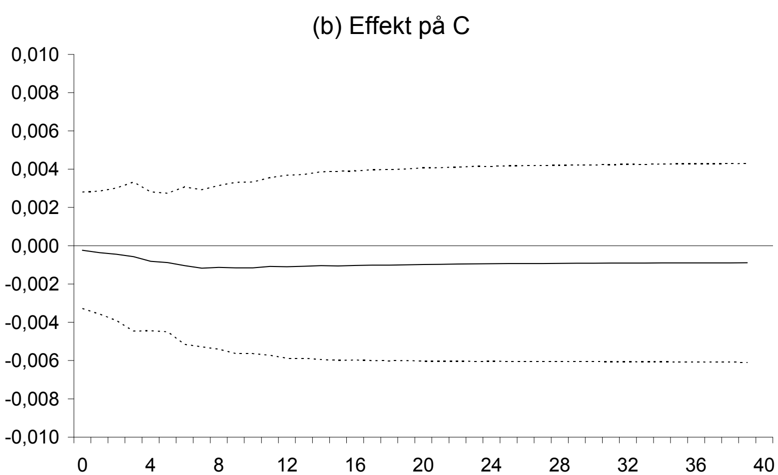
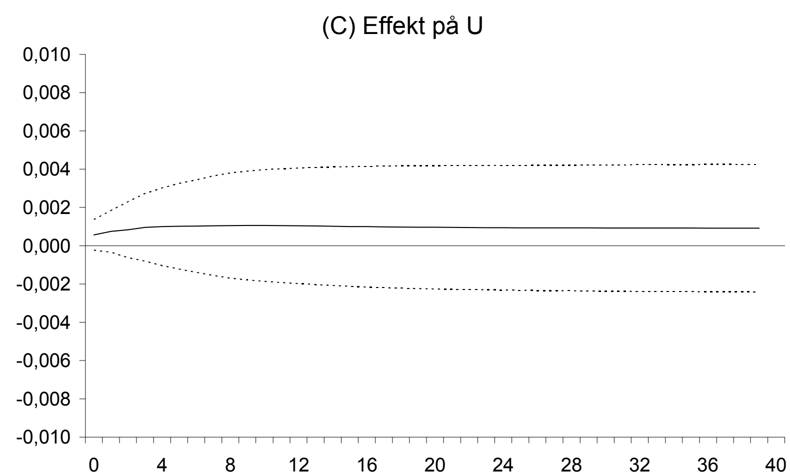
Effect of fiscal consolidation







The surplus target

- Financial net lending of one percent of GDP **over the business cycle**
- Statutory goal increases credibility
- Good that the government makes clear that pre-funding should not be used to meet future costs of higher life expectancy or higher quality of welfare services
- But the government (as well as the opposition) avoids the question of how future welfare services should be financed

Indicators used by the government to assess if surplus target is met, percent of GDP

	2009	2010	2011	2012	2013	2014
Backward-looking ten-year average	**1.3**					
Cyclically adjusted backward-looking ten-year average	**1.4**					
Forward-looking seven-year indicator	**0.7**	**0.5**	**0.3**			
Cyclically adjusted seven-year indicator	**1.4**	**1.6**	**1.6**			
Structural net lending	**2.2**	**0.4**	**0.7**	**1.5**	**2.0**	2.4
Forward-looking ten-year indicator	**0.7**	**0.9**	**1.1**			

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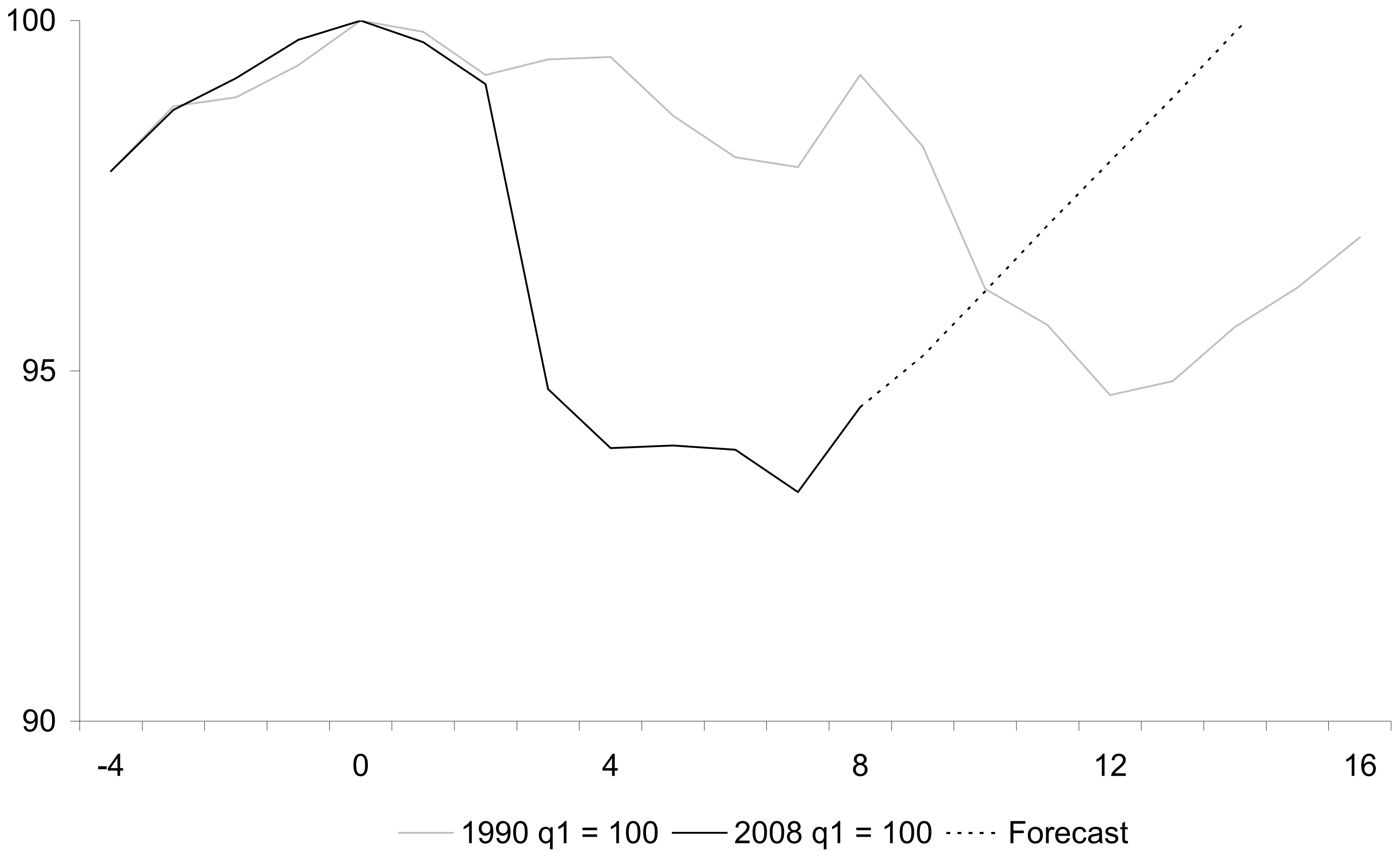
Evaluation of the surplus target

- Not clear if deviations should be compensated
- The government seems to think it is more important to **try** to fulfil the goal in the future than to **actually** fulfil it in a specified period
- Confusion of backward and forward-looking perspective
  - evaluation of whether the goal is met
  - planning tool for future fulfilment of the goal
- Only **two** indicators should be used!
- **Special communication to the parliament if deviation from (at least one of) the targets by some magnitude** (0.5 percent of GDP?)

The labour market

- Smaller decrease in employment, given the fall in output, than in the 1990s crisis
- Private service sector has fared well compared to the manufacturing sector
- No large public sector layoffs
- The government’s labour market reforms?

GDP compared to crisis in the 1990s



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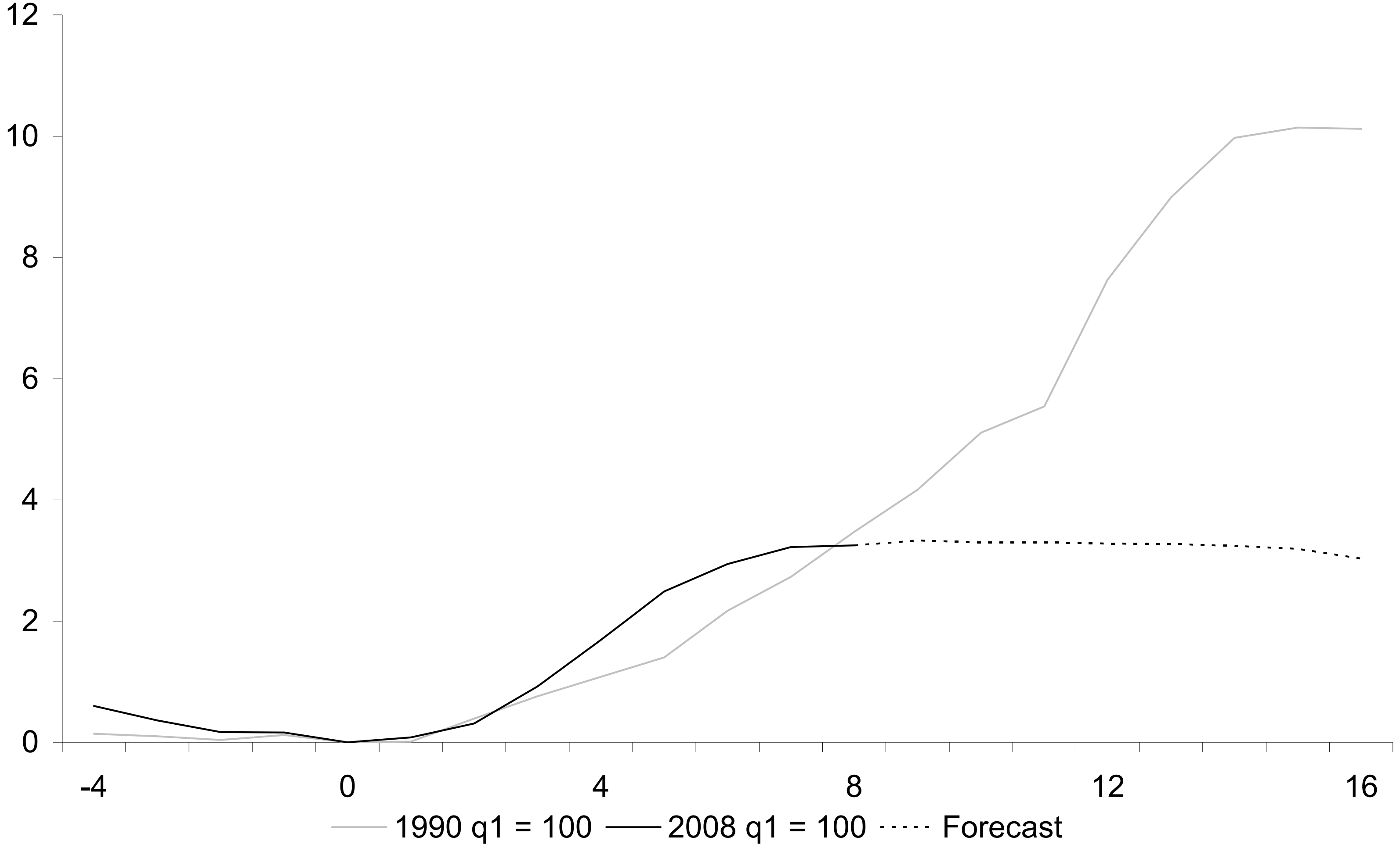
Unemployment compared to crisis in the 1990s, difference in percentage points



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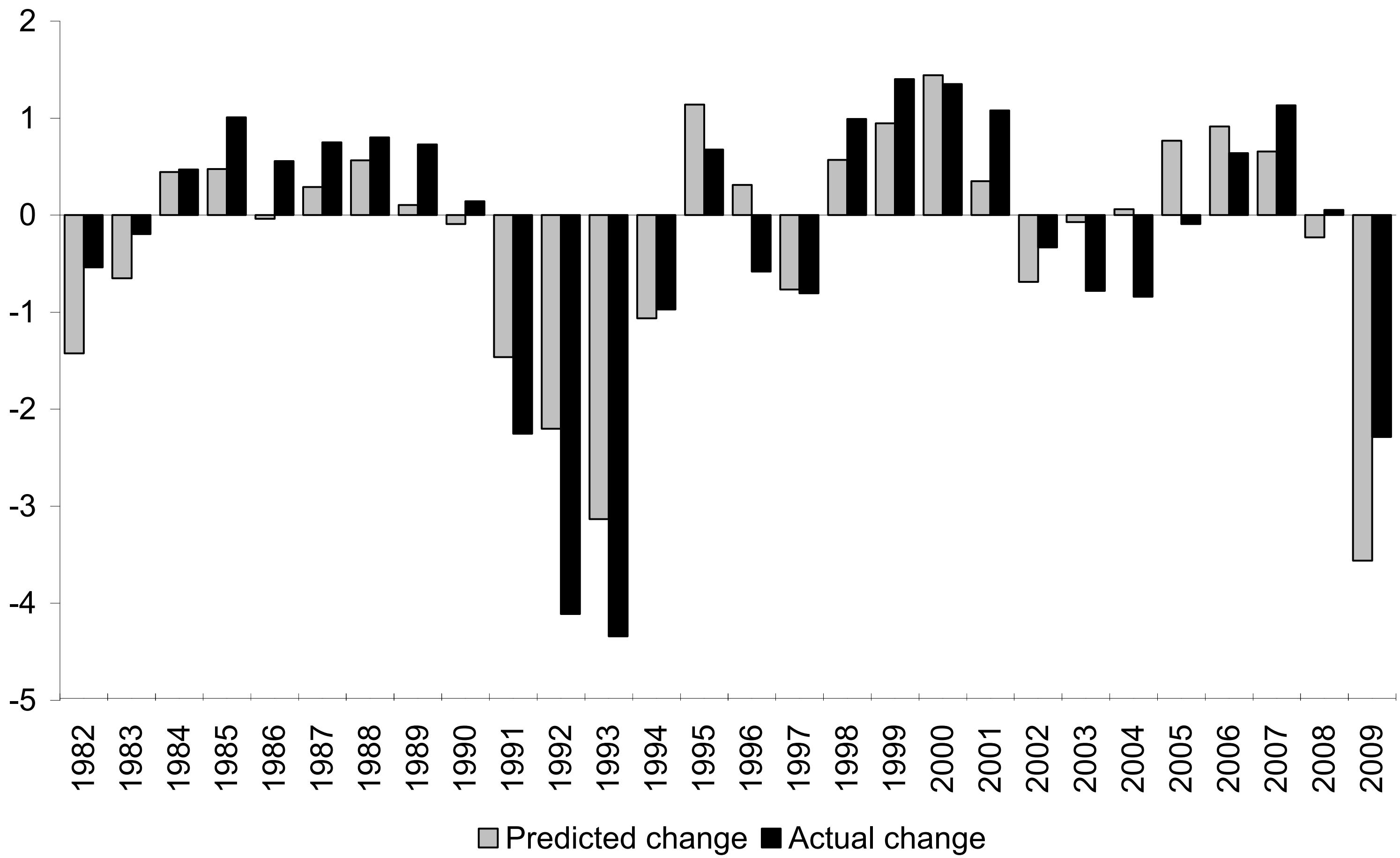
Actual and predicted (using Okun's law) change in employment



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Change in employment rate, percentage points

	All	Young	Old (55-64)	Born outside Europe	No upper secondary education
1990–1992	-5.8	-13.9	-2.4	-12.7	-8.0
1990–1997	-12.4	-26.4	-6.8	-20.0	-14.0
2001–2004	-1.8	-5.1	2.6	-2.5	-4.4
2008 Q1–2010 Q1	-2.8	-5.7	0.6	-	-
2007–2009	-2.2	-5.0	0.0	-2.4	-5.1

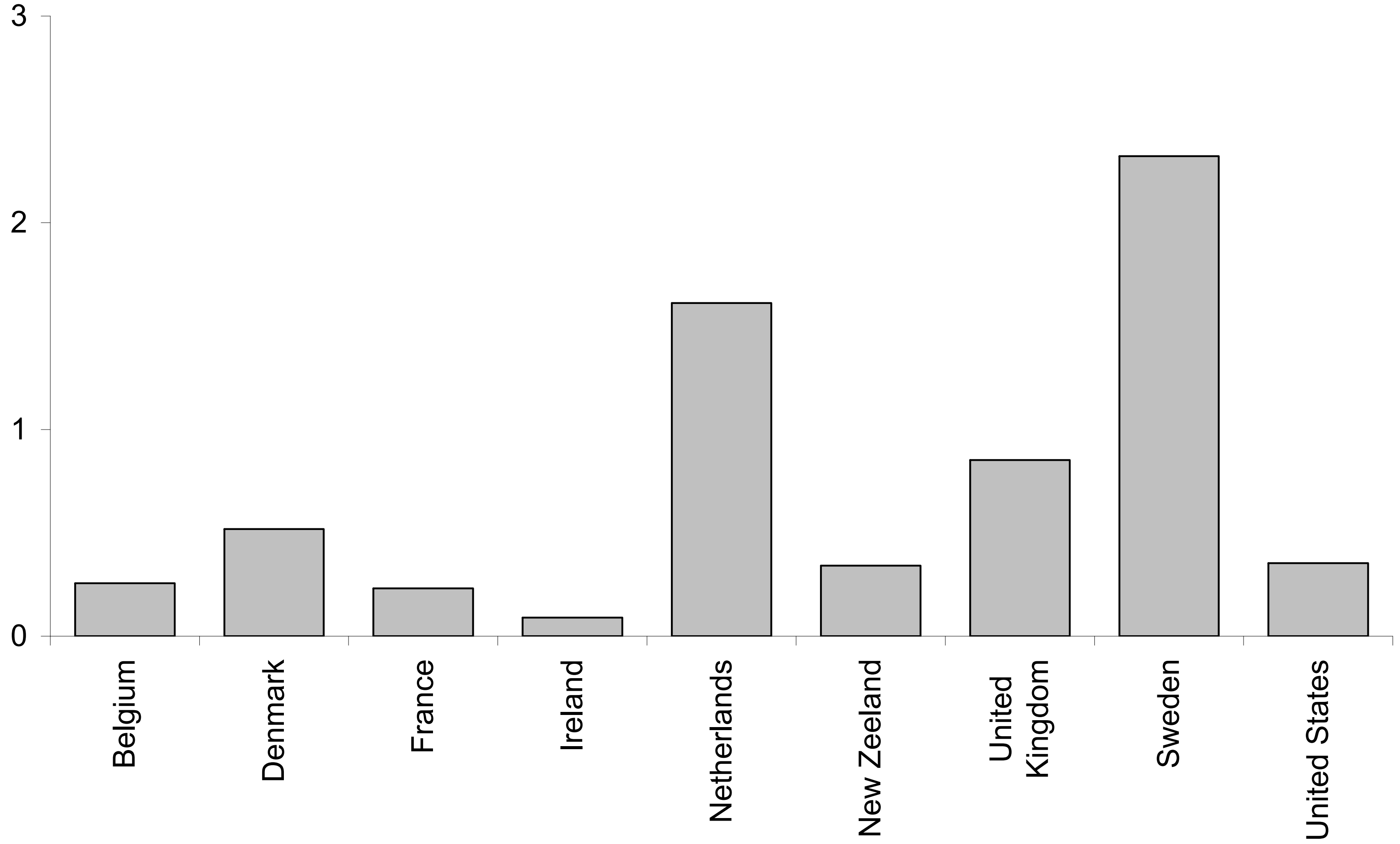
Relative change in employment rate

	Young	Old (55-64)	Born outside Europe	No upper secondary education
1990–1992	2.4	0.4	2.2	1.4
1990–1997	2.1	0.5	1.6	1.1
2001–2004	2.8	-1.4	1.4	2.4
2008 Q1–2010 Q1	2.0	-0.2	-	-
2007–2009	2.3	0.0	1.1	2.4

The earned income tax credit

- 17 of 30 OECD-countries have such credits in some form
- Everyone with an earned income receives credit in Sweden
  - only Denmark and the Netherlands have the same construction
  - common to phase out credit with income
- But a phase-out would imply large marginal effects in Sweden due to high marginal taxes

Direct cost of earned income tax credit in different countries, percent of GDP



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How does the earned income tax credit work?

- Stronger incentives to **supply** labour
- Why does labour **demand** increase?
  - **smaller** wage gains **before** tax
- But **larger after-tax** wage gains
- Why should this be controversial?

The government's estimates of the effects of the EITC

- Increased employment of 80 000 persons in the long run
- The calculations follow best practice
- But best practice is not that good

  - supply effects

  - many effects not accounted for
- Hard to determine if the estimates are too optimistic or too pessimistic
- The government should acknowledge the great uncertainty

Sickness insurance reforms

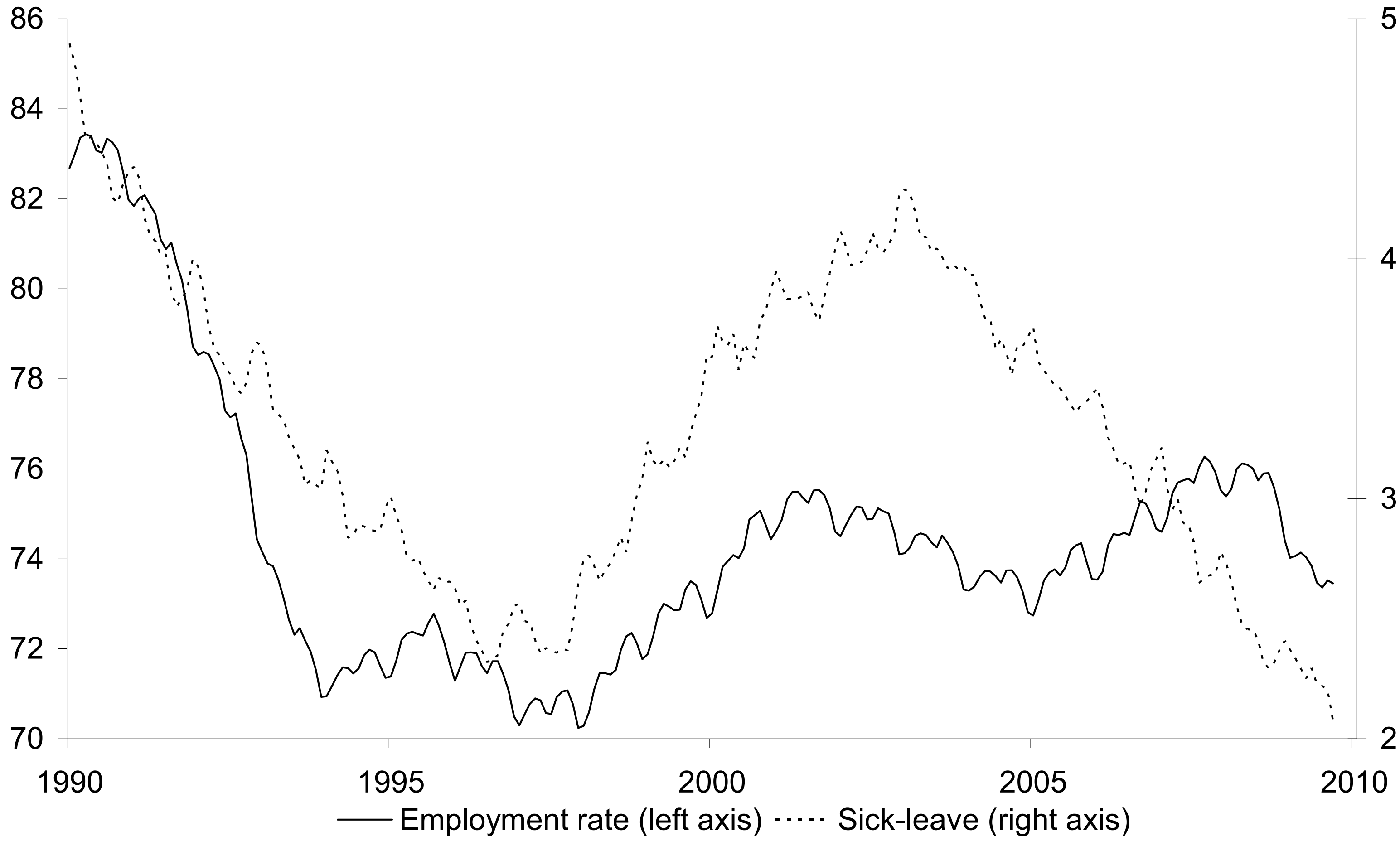
- The government has tackled a difficult problem
- Mistakes are inevitable
- But they have been too many
- Differentiate between **stock** and **flow**

  - new rules could have applied only to the inflow

  - this would have implied experimentation on a smaller scale
- Disability pensions for young people still increasing
- Are the requirements for disability pension too strict for old people?

  - **permanent** instead of **long-lasting** disability

Employment rate and sick-leave, percent of the labour force and employment respectively



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