

EXPENDITURE CEILINGS AND FISCAL POLICY: SWEDISH EXPERIENCES

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1. Introduction

In the late Nineties, the Swedish budget process and fiscal framework were thoroughly reformed. At present (2005), the new system has been in place for seven years. The aim of this paper is to describe this system, with an emphasis on expenditure ceilings, and to discuss the experience so far. The paper is organized as follows: Section 2 presents the reforms of the budget process and the Swedish fiscal framework. In particular, the relation between expenditure ceilings and the surplus target will be explained. Section 3 discusses the track record of the expenditure ceilings, describes the budget margin mechanism and the main elements that set the nominal levels of the ceilings. Section 4 highlights some problems with the system and in Section 5 the functioning of the system over the economic cycle 1998 to 2004 is discussed. Section 6 concludes.

2. Description of the fiscal policy framework¹

2.1 *Budget process and expenditure ceilings*

The Swedish public finances went through two weak periods during the last decades – one in the early Eighties and a second in the early Nineties. The latter episode was the most severe fiscal crisis after the second world war and probably one of the deepest in the industrialized world at the time. This pronounced weakening was influenced by the international slowdown, but had without doubt also domestic causes related to stabilization policy, sequencing of deregulation and to the wage-formation process. At that time it was also observed that the Swedish budget process was rather loose and could have contributed to the crises.² A reform process was initiated, which led to substantial changes in the budget process later in the Nineties. Central features of the new budget process, implemented in January 1997, are a “top-down” budgetary process, with multi-year expenditure ceilings and a medium-term target for the government’s net lending.

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¹ This part draws on Hansson Brusewitz (2002) and Heeringa and Lindh (2001).

² Molander (2000).

The “top-down” budget process assigns a clear role to the Ministry of Finance in drawing up the budget. The multi-year framework includes nominal expenditure ceilings for the coming two or three years. For the two coming fiscal years ($t+1$ and $t+2$) these ceilings are already set by decisions taken in earlier years. The new expenditure ceiling three years ahead ($t+3$) is discussed and decided at a cabinet budget meeting in August. The discussion is based on a proposal from the finance minister. The level of the expenditure ceiling for year $t+3$ is presented to the Parliament in the Budget bill in September and is approved by the Parliament in November. The decision is a guideline decision that can be changed by a new decision by the Parliament. A lot of political prestige has, however, been invested in the expenditure ceiling and there are strong political commitments to maintain the ceiling at the decided level.³

The new budget process also includes a so-called two-stage frame decision process. Total expenditure is divided into 27 different expenditure areas for the coming fiscal year, for each of which the Parliament first determines a budget frame. This decision must comply with the previously set expenditure ceiling for year $t+1$. The Parliament then approves the level of the appropriations within each expenditure area. The total sums of the appropriations must not exceed the previously determined budget frame. Hence, additional spending on one appropriation must be matched with corresponding spending cuts within the same expenditure area, otherwise the proposal will not be allowed to be discussed by Parliament. The new decision process in Parliament has reduced the size of parliamentary amendments to the government’s budget. Indicative frames for the expenditure areas for years $t+2$ and $t+3$ are also approved by the Parliament as starting points for the preparation of future budgets.

The ceiling includes central government expenditures and expenditures for the pension system outside the budget but doesn’t include interest expenditures. It covers approximately two-thirds of total general government expenditures. Cyclically sensitive expenditures, such as expenditures on active labour market programmes, unemployment benefits and social security are included.⁴ Inflation is treated as all other factors affecting expenditures without any automatic adjustments. Interest costs are excluded, according to the argument that in the short term it is not possible for the government to influence them. Local government expenditures are excluded, with reference to the autonomy of this level of the government. The basic rules governing the budget process, including the expenditure ceilings, were collected in a budget act dated 1997.

³ In the period 1997 to 2001 the ceiling for $t+3$ was approved by the Parliament in spring. Since 2002 it is approved in November.

⁴ A motivation for including also cyclically sensitive expenditures is that transparency of the budget rule improves with a broad covering. The cyclical effects are intended to be taken care of by the so-called budget margin, see paragraph 3.2.

Table 1

The Surplus Target: Annual Targets and Outcome
(net lending, percent of GDP)

	2000	2001	2002	2003	2004	2005
Annual Target	2.0	2.5	2.0	2.0	0.5	0.5
Outcome	5.0	2.6	-0.5	-0.1	1.1	-

Source: Swedish Ministry of Finance and Statistics.

2.2 The surplus target

The fiscal policy framework implemented in the late Nineties includes two targets at the national level.⁵ In addition to the expenditure ceiling, there are also surplus targets that cover the general government sector, *i.e.* the central government, local governments and the old-age pension system. The target, which is set for the medium term, is that the general government net lending (according to ESA95) should amount to 2 per cent of GDP per year on average over the business cycle. One indicator of the targets is that the structural surplus (adjusted for the cycle and one-off measures) should amount to 2 per cent of GDP. Other indicators are averages over periods of several years indicating a cycle.

In practical implementation *ex ante*, the medium-term target is translated into an annual target for the actual budget surplus in year t and $t+1$.⁶ This annual target is proposed by the Government in the Budget Bill for the year $t+1$ in September in year t and is approved by Parliament later in the autumn. The targeted surplus could deviate from 2 per cent of GDP for two reasons. First, the cyclical situation (measured as the GDP gap) is normally taken into account when the annual target is set. Secondly, a large initial deviation from 2 per cent could motivate a slower adjustment back to the targeted level than within one year. The annual targets were fulfilled in the years 2000, 2001 and 2004. In 2002 and 2003, an unexpected weak growth contributed to the outcome.

2.3 The aim of the surplus target

The main reason for the surplus target is to reduce public debt to account for the budgetary impact of an ageing population. Thus, the target is forward-looking. The dependency ratio of the elderly related to the working population will increase

⁵ In addition to the targets set at national level, there is also a balanced budget requirement for local governments.

⁶ This is the practice since the Budget for 2003. Earlier annual targets were set for the whole projected period of three years.

rapidly after 2010. A surplus of public net lending of, on average, 2 per cent during the coming decade will reduce public debt and interest payments. This will diminish the need to for budgetary retrenchment (e.g., tax increases) when costs for the ageing population start to rise, and also smooth the tax burden across generations. The sustainability criterion behind the choice of the surplus target is that the debt situation should not deteriorate over a foreseeable period, which is sufficiently long to include the demographical structural change. The estimates presented in the Updated Swedish Convergence Programme for 2004 result in a central government ratio for 2050 that is lower than today. The calculations include the assumption that the surplus target is fulfilled up to 2015.⁷

A second motive of the surplus target is to maintain a large enough margin to avoid excess deficits according to EU fiscal rules, defined as deficits exceeding 3 per cent of GDP, and to fulfil the Stability and Growth Pact's (SGP) medium-term target of a budget position of "close to balance or in surplus". For Sweden, a country with a relatively large expenditure and revenue ratios, a small structural surplus is needed to give room for automatic stabilizers and for other types of budget uncertainty.⁸ However, the Swedish national surplus target is somewhat more ambitious compared to the SGP target. Hence, besides automatic stabilizers, there could be some room for discretionary policies when there are risks for larger output gaps.

The attainment of the medium-term target also helps to support the credibility of the budget policy and thereby supports monetary policy and moderate market interest rates. This may, in turn, have positive effects on investments.

2.4 *Why two targets?*

The surplus target could be seen as the overarching target and the expenditure ceilings as an operational supplement to the surplus target. However, the expenditure ceilings have also their own virtues, as explained in Section 3.

There exist several motives behind the two-target system. First, even if the surplus target promotes long-term sustainability and secures room for automatic and active stabilization policies, it does not constrain the total spending level nor the total tax revenues. However, together with the surplus target, the level of the expenditure ceiling determines an implicit target for the tax level. A separate revenue target is therefore not needed, but a desired tax level could guide the choice of the expenditure ceiling.

⁷ For more detailed presentations of assessments of long term sustainability of Swedish public finances and its relation to the surplus target, see the Budget Bill for 2005, Appendix 2, "Sweden's Economy" (Chapter 13) and the Swedish Convergence Program 2004.

⁸ Empirical estimates show that the so-called semi-elasticity measuring the budget sensitivity with respect to the output gap is approximately 0.7, while it is on average 0.5 in EU-15.

Second, a top-down budget process where a target for total expenditure is decided before expenditure details, makes budget choices more explicit and results in improved argumentation for new spending proposals. This should, in turn, lead to an improved allocation of scarce resources on the budget.

Third, a multi-annual expenditure ceiling set in advance might prevent a situation where temporary high tax revenues are used to pay for permanently higher spending. Hence, a pro-cyclical policy can be avoided in periods of cyclical upturns on the expenditure side of the budget. The multi-annual system supports a long-term direction of fiscal policy, and strengthens its credibility.

In their practical application, expenditure ceilings show advantages over surplus targets. The nominal ceilings are highly transparent, a strict ceiling being expressed as a simple figure in billion SEK, and therefore easy to monitor. The experience so far is that this contributes to the political commitment to keep the target and that there are substantial political costs not to do so. Other institutions monitor the ceilings, most strictly the National Financial Management Authority (ESV).⁹ In several occasions, in the autumn, this authority reported that the ceilings were threatened and such reports are published by the media. So far, in these occurrences the government has always corrected its expenditure policy to comply with the target. The medium-term surplus target, on the other hand, is a symmetric target and less easy to monitor.¹⁰ Measures of structural balances could be used as indicators of compliance but they are notoriously uncertain. Also, the length of the cycle is not a clearly defined concept.

3. Track record of expenditure ceilings, 1997-2004

3.1 *The level of the expenditure ceiling*

General government expenditure as a percentage of GDP rose sharply during an economic crisis in the early Nineties. In 1993 the expenditure-to-GDP ratio amounted to 70.4 per cent of GDP. The savings in the consolidation program that was implemented in 1994, to become fully effective in 1998, contributed to a fall in the expenditure-to-GDP ratio. Between 1998 and 2000, after the completion of the consolidation program, general government expenditure, as a percentage of GDP, continued to decline from 58.2 in 1998 to 54.7 per cent in 2000. This fall in the expenditure ratio was mainly a consequence of relatively restrictive levels of the expenditure ceilings set for those years. As a percentage of GDP, the expenditure ceiling fell by about 2.5 per cent between 1998 and 2000. During the same period the tax ratio increased by about 1 percentage point and general government net lending increased from 1.9 to 5.0 per cent of GDP. Hence, during these years the

⁹ ESV is an authority which, in its activities, operates independently from the Government and the Finance Ministry.

¹⁰ However, annual targets have been formulated as a floor for the surplus. That is, for instance, the case for the annual target in 2005.

Table 2

Expenditure Ceilings Adjusted for Technical Changes
(billions of Swedish Krone)

Year	1997	1998	1999	2000	2001	2002	2003	2004
Expenditure Ceiling	698	695	711	720	746	773	803	836
<i>percent of GDP</i>	36.2	35.2	34.2	32.8	32.9	32.9	32.8	32.4
Expenditure under the Ceiling	674	693	709	715	741	773	800	834
<i>percent of GDP</i>	35.7	35.1	34.1	32.6	32.7	32.8	32.8	32.8
Budget Margin	24.0	2.0	1.5	5.0	4.7	0.4	2.9	2.4

Sources: Ministry of Finance and Statistics Sweden.

expenditure ceiling prevented a situation where temporary high tax revenues, due to a cyclical upswing, were used to finance permanently higher spending.

Corrected for technical changes, the expenditure ceiling has been set at a relatively stable level of almost 33 per cent of the *actual* GDP for the period 2000-04. However, since average economic growth has been lower than trend growth during these years, the expenditure ceiling as a percentage of *potential* GDP has decreased somewhat since 2000. According to the National Accounts, during the same period, primary general government expenditure – including local governments – is expected to increase by about 0.8 of GDP to 52.5 per cent 2004 (see Table 2).¹¹ The expenditure ceilings have, so far, been effective in restraining the growth of public expenditures and in maintaining a structural surplus in general government finances.

Corrected for technical changes, the expenditure ceiling decreased from 36.2 per cent of GDP in 1997 to 32.4 per cent of GDP in 2004. The ceilings that are now in effect up to year 2006 imply that the expenditure ratio will continue to decline over the next few years, but at a lower rate.

3.2 The budget margin

A critical feature of the expenditure ceiling is that it has an *ex post* dimension: it should be implemented in a way such that the outcome of the ceiling-restricted

¹¹ The minor difference between the development of the ceiling to GDP ratio and the central government expenditure ratio according to the National Accounts depends mainly on the fact that certain central government expenditures are reported on the income side in the central government budget and in the National Debt Office's net borrowing.

Table 3

General Government Expenditure and Primary Expenditures
(percent of GDP)

Year	1997	1998	1999	2000	2001	2002	2003	2004
Expenditure	60.5	58.2	57.2	54.7	54.2	55.7	55.9	54.5
Primary Expenditure	54.2	52.7	52.9	50.6	51.1	52.4	53.5	52.5

Sources: Swedish Ministry of Finance and Statistics.

expenditure is below the decided expenditure ceiling. It is not enough that the target is met *ex ante* when the ceiling is determined three years in advance or at the time of budget approval.

Since the ceiling limits the actual expenditure – not just appropriated funds – uncertainty in the expenditure forecast has to be taken into account. To accommodate the impact of unanticipated developments there is a buffer – a so-called budget margin – between the ceiling and the ceiling-restricted expenditures. The main purpose of this budget margin is to absorb fluctuations in the expenditure level due to changes in the business cycle and other macroeconomic uncertainties. The margin should also absorb the uncertainty caused by the fact that Swedish agencies can shift the consumption of appropriated funds between years.¹² However, the budget margin does not only serve as a contingency reserve. Given that the margin is considered sufficiently large to handle uncertainty, the margin also leaves some scope for future spending reforms. Hence, this part of the margin has served as a planning reserve for future spending initiatives not yet decided or announced.

A large budget margin will substantially reduce the risk of an overrun of the ceiling and the need for active measures in case of such a risk. It also gives room for the action of the automatic stabilizers on the expenditure side of the budget to operate. On the other hand, too large a margin softens the budget constraint; so a trade-off has to be made when the expenditure ceiling and the budget margin are determined three years in advance. There is no established principle for determining the appropriate size of the budget margin. When the ceiling has been set for the third additional year in the three-year budget framework, the budget margin has normally amounted to about 2 per cent of the expenditure ceiling.¹³ Since the uncertainty in

¹² For most appropriations there is a carry-over possibility, which means that unused appropriations – within certain limits – can be carried forward to the next year. For most appropriations there is also a possibility – within certain limits – to borrow against the following years' appropriation. Such a credit is automatically deducted from the carry-over fund the following year.

¹³ To understand the principles for the decisions on the ceilings, see paragraph 3.3.

the expenditure level is smaller for the coming two years, a smaller budget margin has been accepted for these years.

Table 1 shows the outcome of budget margins for 1997-2004. We see that the expenditure ceiling has been met every year since its introduction in 1997. In 1997 the budget margin was relatively large in relation to the expenditure ceiling. Between 1998 and 2004, however, the outcome of the budget margin was relatively small, just a fraction of a percent of the expenditure ceiling. The budget margins are also expected to be small between 2004 and 2006.

Since 1998, the budget forecasts for each current year have usually indicated a risk of an overrun of the expenditure ceiling. Among the reasons for this are (i) the new expenditure reforms decided after the level of the expenditure ceiling was approved and (ii) the economic downturn in the economy that began in 2001 (see also Section 5). This development has created a pressure on the expenditure ceiling, mainly through higher-than-expected unemployment benefits. The small budget margins have also – to a large extent – been caused by higher-than-expected costs for sick leave insurance. In 1997 the sick numbers were at a historically low level. In 1998, the sick leave numbers started to increase. This increase was forecasted not to last long. Because the increase from 1997 onwards was not forecasted, it took a long time for the Government to react to it. In 2002, an all-time high was reached. Hence, from 1997 to 2003, the total costs for sickness benefits, including early retirement, rose rapidly. In relation to total ceiling-restricted expenditures, the costs for sick leave insurance and disability pensions increased from 11 per cent in 1997 to 15 per cent in 2003.

The new budget process, with relatively small budget margins under the expenditure ceiling, implies that expenditure forecasting over the short- and medium-term has become a high priority activity in the Government Office. Forecasting now plays a central role both during the budgeting phase and as a component of the in-year monitoring activities.

A lot of political prestige has been invested in the expenditure ceiling. Furthermore, the budget act stipulates that the Government must act to prevent an overrun of the ceiling if there is a risk of such an overrun. There has, therefore, been both a strong political commitment, together with a legal one, to comply with the ceilings. To cope with the ceilings, the Government has most years used its right to set the maximum allowed expenditures below the amounts appropriated by the Parliament by using the so-called “limitation amounts”. Because of the carry-over possibility that is applied to most appropriations in the Swedish budgetary system, the limitation amounts have carried forward expenditure from the current year to the next fiscal year. Therefore, the limitation amounts have not given rise to a permanent reduction of the expenditure level. However, they reduced the level of the budget margin in the following fiscal year and thus the scope for expenditure reforms or increased the need for budgetary retrenchments in that year.

On some occasions, to comply with the expenditure ceiling the government has also proposed permanent savings in, e.g., some transfer systems. Other measures

can also be used. The Government has submitted proposals to the Parliament on exceptions from the normal rule that acquisition of assets of an infrastructural nature shall be financed by appropriations. Instead, the Government has, in a few cases, proposed that acquisition of such assets shall be financed by loans in the National Debt Office. This means that accounting in relation to appropriations and the expenditure ceiling takes place in future years when the loans are amortized and not in the fiscal year to which the investment expenditure relates. Hence, just like in the case with limitation amounts, loan-financed infrastructure projects tend to reduce the level of the budget margin in the following fiscal years. The Government has also used *tax expenditures* or *net budgeting* of fees as a remedy when the expenditure ceilings have been threatened (see below). It should, however, be observed that the introduction of new tax expenditures have not been used as a substitute for existing expenditure programs but as a substitute for new expenditure reforms.

3.3 Principles for the decisions on the expenditure ceilings

When the ceiling for the new third coming fiscal year is to be set, the previously decided expenditure ceilings for the first two years are maintained, unless very strong reasons justify modifications of the ceilings. So far, the ceilings have been maintained at the previously decided levels, with exceptions for some technical adjustments.¹⁴

Several factors are normally taken into consideration when the level of the expenditure ceiling is determined. One factor is that the expenditure ceiling affects the scope for tax reforms or the need for tax hikes over the medium-term. The desired level of future tax reforms should therefore be taken into consideration when the ceiling is proposed. Equation (1) illustrates the relation between the desired level of tax reforms for year ($t+3$), ΔT_{t+3} , and the level of the expenditure ceiling, C_{t+3} :

$$C_{t+3} = R_{t+3} + \Delta T_{t+3} - S - OE_{t+3} + M \quad (1)$$

where R_{t+3} denotes projected general government revenues assuming unchanged tax rules for year ($t+3$),¹⁵ S is the desired structural level of general government net lending (2 per cent of GDP), and OE_{t+3} is projected net expenditures outside the

¹⁴ Such adjustments have been made several times due to policy changes that have affected the ceiling-restricted expenditures without affecting the consolidated expenditures of the general government sector. After the technical adjustment of the expenditure ceiling, the margin between the new ceiling and ceiling-restricted expenditures should in principle be the same as before the change that gave rise to the adjustment.

¹⁵ When the level of the expenditure ceiling for the third coming year is to be determined, the output gap is normally assumed to be approximately zero for that year. Hence, the tax forecast for year $t+3$ normally shows expected tax revenues collected at the potential level of GDP. This means that a calculation of the level of the expenditure ceiling made in accordance with equation (1) is based on tax revenues obtained at the potential level of GDP. Higher-than-expected tax revenues due to a cyclical upturn (resulting in a positive output gap) will therefore be used to improve the budget balance (given that the expenditure ceiling is a more or less binding constraint).

ceiling (mainly, projected local government expenditures and interest on central government debt). The level of ceiling-restricted expenditures that are compatible with the planned tax measures then equals $R_{t+3} + \Delta T_{t+3} - S - OE_{t+3}$. By adding an appropriate budget margin (M), one obtains the desired level of the expenditure ceiling.

The difference between the maximum planned expenditure level that follows from the expenditure ceiling ($C - M = R_{t+3} + \Delta T_{t+3} - S - OE_{t+3}$) and the consequent assessment of how large the expenditure will be for the coming third year (if the measures already decided are implemented) then shows the potential scope for expenditure reforms for that year.¹⁶ If this difference is negative there is instead a need for budgetary retrenchments on the expenditure side of the budget.

Hence, by choosing an appropriate level of the expenditure ceiling this way, a projected structural budget surplus in excess of 2 per cent of GDP can be divided between a scope for future desired tax reforms and a scope for future desired spending reforms. If the projected structural budget surplus instead is below 2 per cent of GDP, the difference is instead divided into expenditure retrenchments and tax boosts.

A problem with the top-down method of determination of the level of the expenditure ceiling in equation (1) is that it requires information on desired future tax reforms and the budgetary impact of such reforms. Because of this problem, the expenditure ceilings have also been determined on the basis of other factors and considerations. One is the relation between the expenditure ceiling and GDP. As mentioned above, the expenditure ceiling has – since year 2000 – been set at an approximately constant level of GDP. For a given level of the surplus target and local government expenditure, this means that the government has planned for an approximately constant level of the overall tax burden over time when the expenditure ceilings were determined.¹⁷ It is also seen as important to avoid a trend growth in the expenditure ratio during the current decade, because of the future budgetary impact of the ageing population after year 2010.

4. Problems

A drawback with hard budget constraints is that they might encourage the use of dubious accounting practices, thereby reducing the degree of transparency in the government budget.¹⁸ Normally, such operations give the government some margin of flexibility in the implementation of fiscal rules. In the case of Sweden, that has a rule on the aggregate level of central government spending, the easiest way to

¹⁶ This difference also equals the difference between the projected budget margin, which follows from the consequence assessment and the contingency reserve.

¹⁷ Surpluses well above 2 per cent in 2000 and 2001, however, gave room for tax cuts.

¹⁸ This is, for instance, discussed in Kopits (2001) and Milesi-Ferretti (2001).

circumvent the expenditure ceiling is to introduce net accounting or subsidies on the revenue side of the budget (tax expenditures).

As a rule, the Budget Act prescribes that the state budget shall, in principle, include all government revenue and expenditure, and that revenue and expenditure shall be entered gross in the state budget. However, the Parliament may decide on exceptions to these rules. This has occurred on a few occasions, when the Government was given authority to decide on the disposition of certain revenues from user fees. This means that related expenses are no longer accounted for in the state budget. The effect of these operations on ceiling-restricted expenditures have, however, been relatively small and the proposals have been presented to the Parliament in a transparent way.

Another potential problem related to the expenditure ceiling is the use of tax expenditures. A tax expenditure exists if there is a deviation between the tax system and a certain benchmark or norm. In Sweden, tax expenditure estimates have been published annually since 1996 in the Spring Fiscal Policy Bill. The report covers most types of taxes, for example, the national and the local personal income tax, the corporate income tax, social security contributions and most indirect taxes. More than 150 different tax expenditure items are included in the report. Currently, total reported tax expenditures amount to about SEK 250 billion or about 8 per cent of GDP. Some of these tax expenditures are very close substitutes to ordinary expenditures, e.g. the so-called “employment support” that is paid to local governments by crediting their tax accounts. Tax expenditures that can be directly compared to public expenditures amount to about 0.4 per cent of GDP.¹⁹ Other tax expenditure items are less close substitutes of ordinary expenditures. Theoretically, proposals for new tax expenditure items that take place after the level of the expenditure ceiling has been set, should be accompanied by a proposal for a downward technical adjustment of the ceiling. However, because of the varying degree of substitutability between tax expenditures and ordinary expenditures, it is difficult to establish unambiguous rules for such technical adjustments. Hence, new tax expenditures have not usually been followed by a proposal for a technical adjustment of the expenditure ceiling. Small budget margins under the expenditure ceiling have led to increased pressure for tax expenditures. This pressure has, however, to some extent been held back by the surplus target.²⁰

Hard budget constraints might increase the temptation to present biased expenditure and revenue forecasts. By strategically manipulating the budget assumptions, the government can abide by the law and then have a list of explanations as to why the targets were missed *ex post*. The risk of a political element in budget forecasting can probably be reduced if the government is committed to meet the fiscal rule both *ex post* and *ex ante* and if independent agencies outside the Government Office monitor the budget and produce independent budget forecasts. Currently there are three domestic bodies outside of

¹⁹ In accordance with general accepted accounting practice in the Central Government's Annual Report.

²⁰ Tax expenditures have also been discussed in Boije (2002).

the Government Office that monitor budget execution and produce independent short-term and medium-term forecasts for central government finances.²¹ Naturally, the Swedish public finances are also monitored by the EU Commission and the Council in the context of the SGP. Since these forecasts are made public, it may be hard for the Government to present budget forecasts that differ too much from the external forecasts without presenting a clear motivation for the deviation.

5. The fiscal framework in different cyclical situations

In the period after the expenditure ceilings were introduced in 1997, the Swedish economy has roughly experienced a full business cycle. The period 1998-2000 included "good years" with an average growth rate of 3.8 per cent *per annum* and a positive output gap in 2000. On the contrary, the period 2001-03 was economically weaker. Average GDP growth rate amounted to 1.5 per cent of GDP with the largest negative output gap in 2003, approximately 1.5 per cent of GDP. 2004 was again a year with higher growth, around 3.5 per cent. The profile of the cycle did not diverge much from those of most other countries in the European Union, although the average growth rate over the whole period was somewhat higher compared to the European average.

Below, the expenditure ceilings and their coordination with the surplus targets in two different cyclical situations are discussed.

5.1 Expenditures in the boom years, 1998-2000

In the period of "good years", the expenditure ceilings constituted a distinct limit to spending. As was intended, the central government expenditure-to-GDP ratio fell by 2.5 per cent of GDP between 1997 and 2000 and reached 32.4 per cent. Windfall gains generated by the buoyant cyclical upswing were directed towards amortization of the central government debt and, to some extent, towards tax cuts. At the same time, the surplus targets were easily met and in large the fiscal framework seemed robust and to function well. By setting limits on total expenditures, the ceilings supported sound counter-cyclical policies. Doubtless, without the ceilings, fiscal policy would have been more expansionary. The framework was however not really tested, due to an unusually favourable macroeconomic development.

In addition to a sustained growth and low unemployment in this period, inflation was moderate. On average, CPI rose by only 0.4 per cent *per annum*.

²¹ The National Debt Office publishes forecasts of the central government borrowing requirement for the current year and the coming fiscal year. The National Financial Management Authority publishes medium-term forecasts of central government revenues and expenditures (as well as ceiling-restricted expenditures) about four times per year. The National Bureau of Economic Research quarterly publishes medium-term forecasts of central and general government net lending as well as forecasts of ceiling-restricted expenditures.

Compared to the forecasts and projections in the *Budget Bill for 1998*, growth developed 1.0 per cent faster *per annum* and CPI inflation turned out 1.3 per cent lower *per annum*. As several transfers in the Swedish system are indexed to the development of CPI (with a lag), low inflation mitigated the pressure on the ceilings. This development was also reinforced by the budget effects of declining unemployment. At the same time, budget margins reserved for cyclical effects on the budget in “bad times” were more or less fully used up. These margins appeared to be soft restrictions and constituted a weak part of the framework. All together, there was room for discretionary, and to some extent permanent, increases in non-cyclical expenditures. Examples were increased expenditures for *education and research* and *economic security for families and children*. The pressure on higher expenditures was, however, also reinforced by the substantial increase in expenditures for *economic security in case of illness and disability*, i.e. the sick leave insurance and early retirement schemes between 1998 and 1999 and, after that, their trend-wise growth up to 2003, see also Section 3.²²

To sum up, expenditure ceilings contributed to counter-cyclical policies in this period by giving strict limits for total expenditures, but there was also an embryo of pro-cyclical policies later on, due to the failure to preserve budget margins for later periods when expansionary fiscal policies were needed.

5.2 *The slowdown in 2001 to 2003*

In the weak economic situation 2001 through 2003, surpluses deteriorated from approximately 5 per cent of GDP to just around balance. Roughly two thirds of the deterioration was due to discretionary fiscal policy measures and one third to automatic adjustments. In the first two years of the slowdown, fiscal policy was strongly expansionary, including both tax cuts amounting to approximately 2 per cent of GDP and increased expenditures of around 1 per cent of GDP. In 2003, the last year in the prolonged slowdown, the fiscal stance turned less expansionary and included only modest expenditure increases (0.2 per cent of GDP).²³

The pressure on the ceilings for cyclical reasons was not that hard in 2001 and in the election year 2002, but grew stronger in the two successive years. This reflects the lagged effect on expenditure of the low CPI inflation in earlier years and that unemployment only increased late in the slowdown. In these years there were two other distinct factors behind the pressure on the margins. First, as mentioned above, active expansionary fiscal policy was substantial, executed in part at the expenditure side of the budget. Major expenditure increases were directed towards increased *child allowances*, *education and research* and to *health care*, *schools* and *social services*, the latter by increased grants to local governments. Most of this expenditure increases must be seen as permanent measures. Second, the costs for

²² *Spring Fiscal Policy Bill 2004*.

²³ See the *Updated Convergence Programmes for Sweden, 2001 to 2004*.

illness insurance and early retirement grew rapidly in a trend-wise and non-cyclical way. It is also notable that expenditures related to labor market policy (a semi-automatic stabilizer) did not increase as could be expected in the slow-growing economy, not even in 2003 when unemployment clearly picked up. An interpretation could be that automatic stabilizers on the expenditure side of the budget were hampered by pressure on the ceilings by used-up margins of other reasons.

The net lending surplus then shrank to close-to-balance as a result of automatic adjustments and active fiscal policy. Due to the prolonged slowdown, it continued to stay below 2 per cent of GDP both in actual and structural terms.

6. Reflection and conclusions

A first reflection is that the Swedish reform in the late Nineties was a typical example of how a severe economic and budgetary crisis made a reform necessary.

A general conclusion is that the nominal expenditure ceilings have functioned well. First, the government has, in the period 1997-2004, *i.e.* for eight years, complied with the ceilings. The expenditure ceilings have helped the Swedish Government to eliminate its deficits and to stabilize public finances. Between 1997 and 2004, the expenditure ceiling has contributed to a fall in general government expenditure ratio from 60.5 to 54.4 percent of GDP. The new process with expenditure ceilings is also felt to have increased long-term programming, because decisions on expenditure ceilings are taken early in the process.

A further consideration is that there might be some truth in the proposition that strict rules – to some extent – promote incentives to circumvent them. The Parliament has, in some occasions, decided on exceptions from the rule of gross accounting. The introduction of subsidies on the revenue side of the budget, the so-called tax expenditures, could also be seen as a circumvention of the expenditure ceiling. These measures have however been relatively small in relation to the total expenditure level.

The so-called budget margin under the expenditure ceilings was introduced to take care of the impact of cyclical and other unanticipated developments affecting the budget. With the exception of the first year with the ceilings, 1997, these margins have been very small even in the period of “good years”, which was not the intention. This could have hampered automatic stabilizers at the expenditure side.

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