THE IMPORTANCE OF FISCAL POLICY FRAMEWORKS – SWEDISH EXPERIENCE OF THE CRISIS

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The unfavourable development of public finances in many European Union countries during the current crisis has intensified the discussion on the importance of national fiscal policy frameworks. The Swedish fiscal policy framework is interesting in this context. As one of few EU countries, during the present economic crisis Sweden has been able to combine significant fiscal stimuli with limited deficits. Deficit and debt levels have also stayed below the levels set by the SGP. We argue that the relatively favourable development of the Swedish public finances both before and under the crisis, to a large extent, can be attributed to the national Medium Term Budgetary Framework combined with a strong political support for the framework. To strengthen the framework the government recently introduced a Code of Conduct for fiscal policy.

1 Introduction

The economic crisis that started in 2007 has led to a rapid deterioration of public finances in most advanced economies. In many of the countries where fiscal deficits were large before the crisis began, deficits have reached or approached double-digit levels, raising concerns about the sustainability of public finances. In some countries (Greece, Ireland and Portugal being the most prominent examples), this development has not only contributed to significantly increased risk premia, but also accentuated the sustainability problem and made stabilisation policy measures less effective.

The unfavourable development of public finances in many EU countries has renewed the discussion on the need to strengthen the Stability and Growth Pact (SGP). Besides suggestions on how the Pact itself can be strengthened, the importance of national Medium Term Budgetary Frameworks (MTBFs), as a complement to the Pact, has been emphasized. The European Commission (2010b) has proposed a directive that would set minimum standards for national budgetary (or fiscal) policy frameworks. This proposal is currently being negotiated between the commission, the council and the parliament with the intention to reach an agreement before the end of spring 2011.

As one of few EU countries, during the present crisis, Sweden has been able to combine significant fiscal stimuli with limited public deficits. In addition, deficit and debt levels have stayed below the levels set by the SGP. We argue that the relatively favourable development of Swedish public finances both before and during the crisis, to a large extent, can be attributed to the national MTBF combined with a strong political support for the framework. The framework, introduced 1997-2000, consists of a surplus target for *general* government, an expenditure ceiling for *central* government (combined with a stringent top-down budget process), and a budget-balance requirement on *local* governments. Both the former social democratic governments and the current center-right government have, largely, respected the framework. During its first term of office 2006-2010, the current government strengthened the framework by making central parts of it mandatory by law. Recently the government has strengthened the framework further by introducing a Code of Conduct for fiscal policy.

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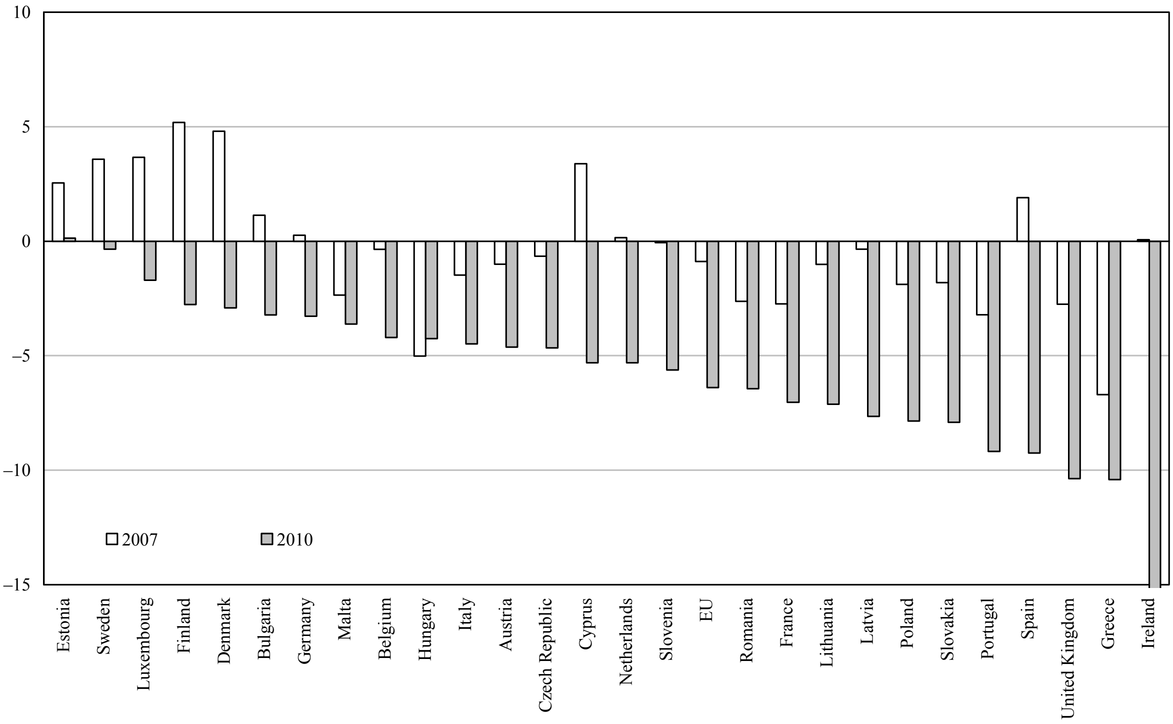
The views expressed herein are those of the authors and should not be attributed to the Swedish Ministry of Finance.

Figure 1

Net Lending
(percent of GDP)



Source: AMECO-database.

The purpose of this paper is to contribute to the debate on the significance of MTBFs by describing the Swedish framework, how it has functioned and recent improvements of it.[1] The paper is organized as follows: Section 2 compares the development of public finances in Sweden and other EU-countries during the financial crisis that began 2008. We evaluate to what extent Sweden and other EU-countries have managed to abide by the numerical rules in the SGP both before and under the financial crisis. In addition, we discuss the role of MTBFs as a mean to improve fiscal performance. Section 3 describes the Swedish MTBF and its background. In Section 4 we assess the performance of the Swedish MTBF. In Section 5 we discuss what constitutes an effective MTBF and to what extent the Swedish framework is designed in accordance with those findings. In Section 6 we briefly describe the content of the Swedish government's Code of Conduct for Fiscal Policy. Section 7 concludes.

2 Public finances in Sweden and the EU – A comparison

The financial crisis affected public finances in all EU countries. Still, there is a wide variety in public deficits 2010 (see Figure 1); from a small surplus in Estonia to –32.3 per cent in Ireland. It is therefore relevant to discuss the causes of these large differences between countries.

[1] Se also Boije, Kainelainen & Norlin (2010) and Boije & Fischer (2009).

Table 1

Comparison Between EU-countries with and without Surpluses in 2007
(percent of GDP)

	Net Lending 2010	Change in Net Lending 2007-2010	Change in Output Gap 2007-10	Stabilisation Policy Measures	Fiscal Rules Index
Surplus countries 2007	–4.1	–6.7	–7.8	9.2	1.2
Non-surplus countries 2007	–6.7	–4.7	–8.1	7.3	0.4

Note: Ireland has been excluded due to its extreme net lending in 2010 (–32.3 per cent of GDP). In 2007 its net lending was zero.
Source: European Commission (2009, 2010a), AMECO-database and own calculations.

2.1 Bailouts of financial institutions do not explain differences in net lending

One popular explanation to the differences is that it is connected to that some countries had to bail out financial institutions. This is certainly the case for individual countries like Ireland. Historical evidence shows that severe financial crises almost invariably are accompanied by massive increases in government debt. In a sample of 13 financial crises after World War II, described by Reinhart and Rogoff (2009), the increase in real public debt following the crisis averages 86 per cent. Most of these build-ups, however, are attributed, not to the cost of bank bail-outs, but mainly to decreased tax revenue and to increased government spending to fight the recession. IMF (2010) shows that the same factors largely explain today's deficits in the G7-countries, while support to financial institutions accounts for less than 10 per cent of the forecasted growth of government debt between 2008 and 2015.

2.2 The importance of securing surpluses during good years

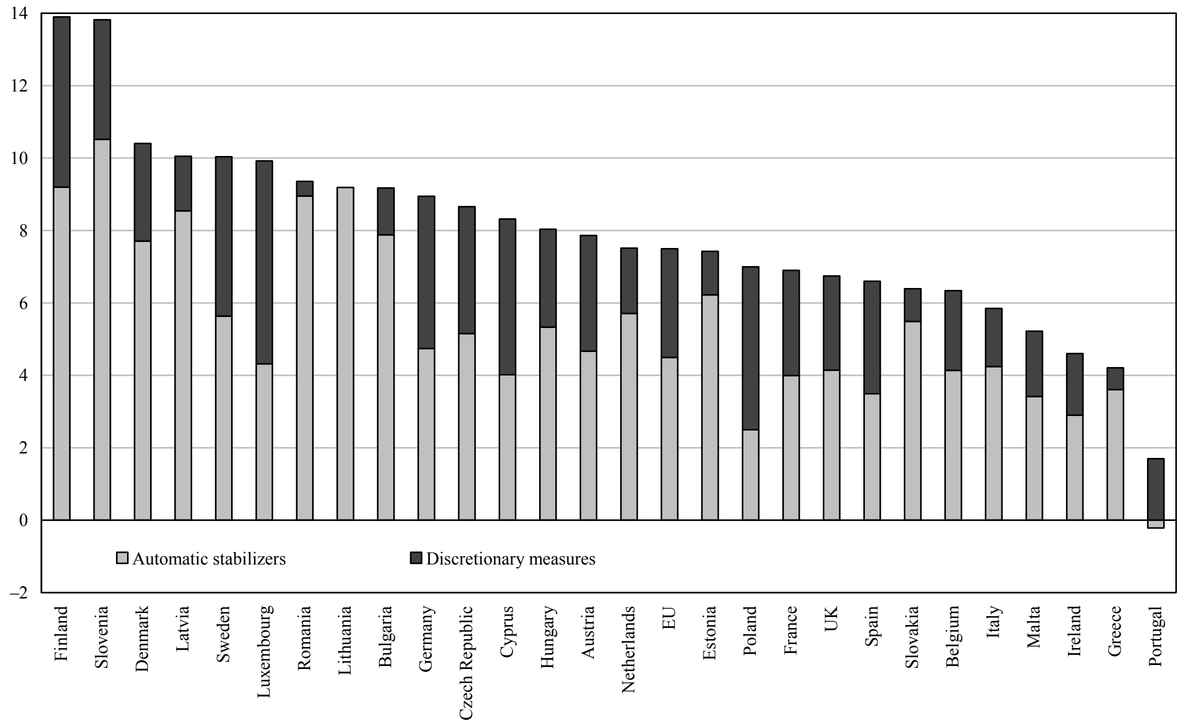
Empirical research shows a tendency for economic upswings to be followed by significant deteriorations in structural positions; when revenue is high, governments find it difficult to resist demands for increased spending or decreased taxes (Joumard and André, 2008). Institutions that promote surpluses in good times can therefore contribute to smaller deficits in bad times.

For the EU countries, there is substantial differences between the eleven countries that had surpluses in 2007 and the ones that had deficits already before the crisis (Table 1). Generally, the deficits for 2010 in countries that had surpluses before the crisis are substantially smaller at –4.1 per cent of GDP as compared to –6.7 per cent of GDP in the countries running deficits in 2007. This does not follow from a smaller decrease in net lending; net lending fell more in surplus countries. Output gaps widened about as much in both groups of countries. Furthermore, the surplus countries made larger stabilisation policy efforts (Table 1 and Figure 2).[2] In the eleven EU countries running surpluses in 2007, measures to meet the economic crisis have averaged 9.2 per cent of GDP as compared to 7.3 per cent in the other countries. Furthermore, the five countries with the largest deficits in 2010 had undertaken combined measures that average 6.6 per cent of GDP as compared to 10.0 per cent in the five countries with the smallest deficits in 2010.

[2] Stabilisation efforts are defined as the combination of automatic stabilizers and discretionary measures.

Figure 2

Stimulatory Fiscal Policy Measures in 2008, 2009 and 2010 Compared to 2007
(percent of GDP)



Source: European Commission (2010a), AMECO-database and own calculations.

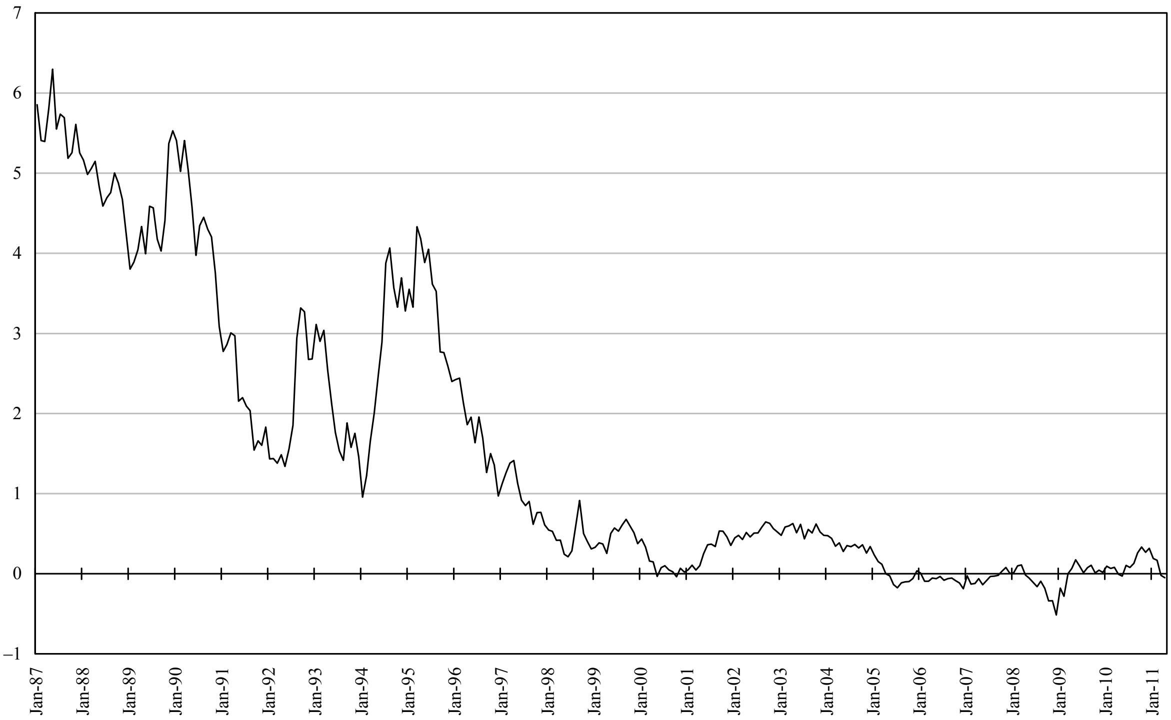
The conclusion from this simple comparison is that countries with surpluses in 2007 have done more to combat the crisis than the countries that ran deficits in 2007, yet the former still have smaller deficits. This illustrates the importance of maintaining surpluses in good years. The Swedish experience is interesting in this context. Even though the financial crisis affected Sweden to the same extent as other countries in terms of loss of GDP, the effect on the public finances has been less severe. In an international comparison, Sweden's current fiscal position is very strong. The deficit was limited to 0.3 per cent of GDP in 2010 and the forecast is that net lending will return to show a surplus in 2011. At the same time, Sweden is one of the EU countries that have pursued the most active contracyclical fiscal policy during the crisis (Figure 2). This combination was made possible by the substantial surpluses in the years preceding the crisis.

2.3 The effectiveness of stabilisation policy during the crisis

Surpluses in Sweden the years before the crisis and the resulting low public debt have given the financial markets confidence in the sustainability of the Swedish public finances, especially compared to the situation in the early 1990s and to that in many other EU-countries today. The interest rate spread to Germany has been close to zero since 2006 (Figure 3). This has been important, not only for the long term sustainability of public finances per se, but also for the effectiveness of the stabilisation policy measures implemented to combat the crisis. Thus, it is a pre-requisite for the effectiveness of stabilisation policy to secure surpluses during good years.

Figure 3

Swedish Interest Rate Spreads Against Germany for 10-year Bonds
(percent of GDP)



Source: Ecowin.

2.4 SGP compliance

Figure 4 shows that in 2010 Sweden was one of only three EU countries which was able to keep the deficit and debt within the SGP's numerical fiscal rules. Figure 5 shows that Sweden has abided by these numerical rules in every year since 2000. The debt ratio has been below the 60 per cent level and it is expected, despite the crises, to fall towards 25 per cent of GDP in 2014. Between 2000 and 2009, there are several countries, which as an average, stayed inside the target levels (Figure 6). Sweden, Estonia, Luxembourg and Finland, however, are the only EU countries that during this period never exceeded the SGP target levels.

2.5 The role of the Swedish MTBF

Our assessment is that the Swedish MTBF has played a key role in securing surpluses in good times and limiting deficits in downturns. In addition, it has contributed to low risk premia, and an effective stabilisation policy. The framework has also contributed to that Sweden all years has abided to the SGP rules. Existing empirical studies generally shows that tighter and more encompassing fiscal rules are correlated with stronger cyclically-adjusted primary balances.[3]

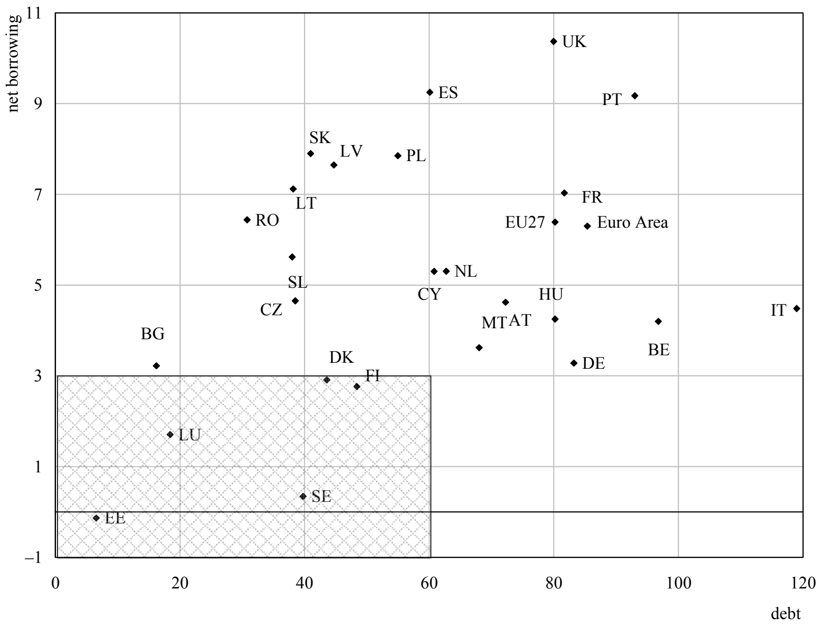
[3] See IMF (2009) for a brief overview of the literature. It's important to note that there are methodological difficulties in assessing the impact of fiscal rules on fiscal performance. In particular, both fiscal rules and improved fiscal performance could be affected by the omission of determinants of fiscal behaviour, such as political or budgetary institutions or processes. A stronger political commitment to fiscal discipline, for instance, could lead to both an improvement in performance and the adoption of rules.

Furthermore, there is empirical evidence suggesting that strong fiscal rules lead to lower interest rate risk premia.[4]

It is clear, however, that a strong MTBF *on paper* does not guarantee sound public finances. The European Commission (2009) has constructed a fiscal rule index, which encapsulates the strength and coverage of domestic fiscal rules. The latest edition of this index describes the situation in 2008 (see Figure 7). According to the index, the fiscal rules were the strongest in the UK, Denmark and Bulgaria, while they were weak in Greece, Cyprus and Malta. An empirical analysis by the European Commission (2009) shows a link between the index and budgetary outcomes in the period 1990-2008. Moreover, Table 1 shows that EU countries that had surpluses before the financial crisis began, on average also had a considerable higher fiscal rule index as compared to the non-surplus countries. However, countries with a strong index-rating do not necessarily have strong public finances at present. The countries with a relatively high index-rating include the UK, Spain and Lithuania,

Figure 4

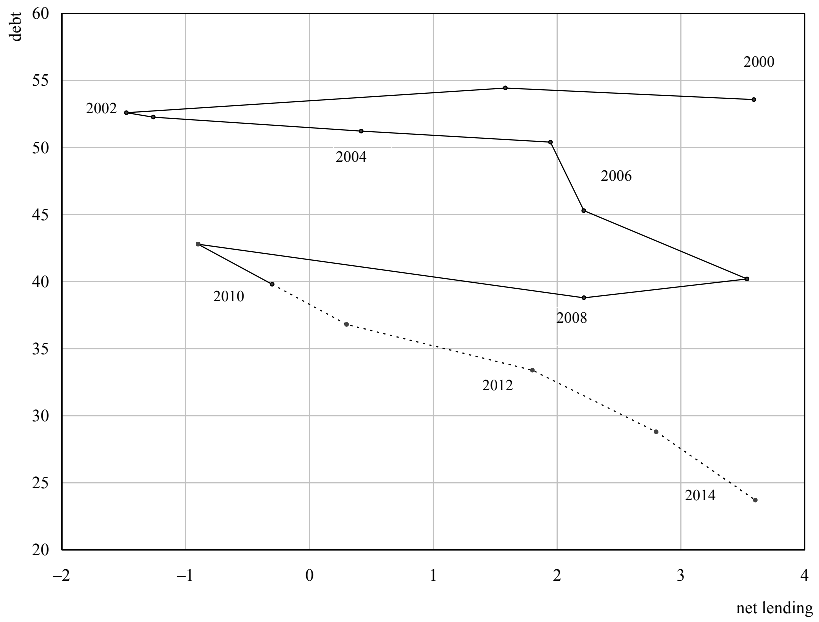
SGP Compliance in EU Member States, 2010
(percent of GDP)



Source: AMECO Database.

Figure 5

SGP Compliance for Sweden, 2000-14
(percent of GDP)

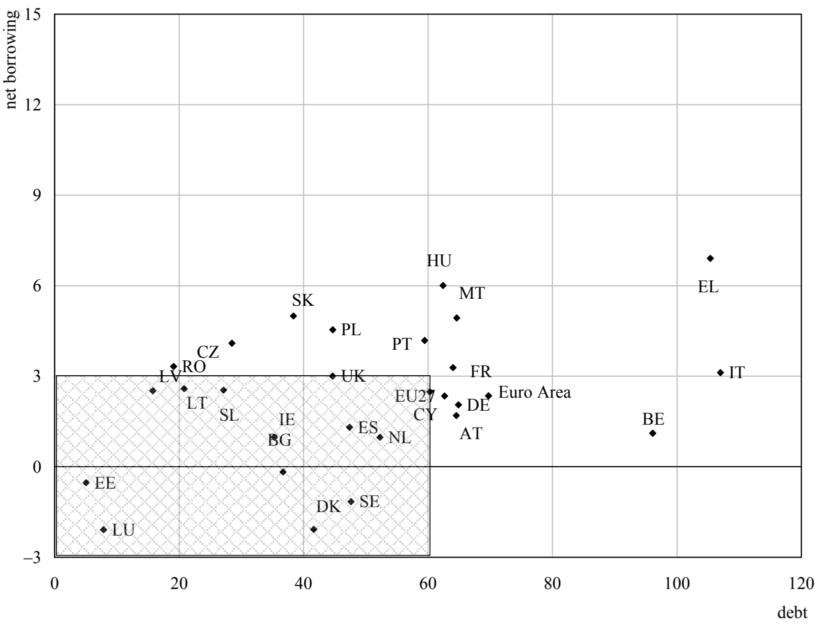


Source: Ministry of Finance and Statistics Sweden.

4 Iara and Wolff (2010).

Figure 6

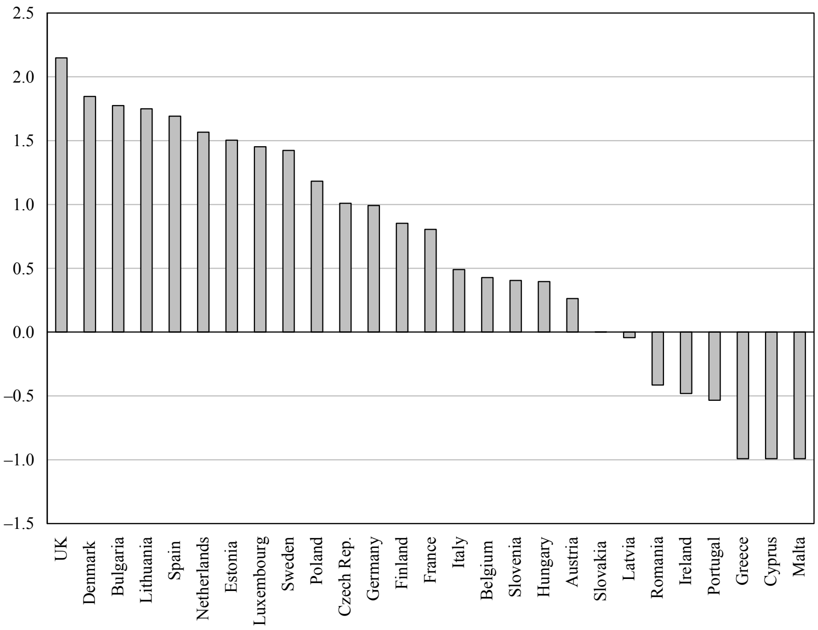
SGP Compliance in EU Member States, Average 2000-09
(percent of GDP)



Source: AMECO Database.

Figure 7

Standardized Fiscal Rule Index, 2008



Source: European Commission (2009).

countries in which public finances at the moment are weak.

Given the difference in experience of countries with strong fiscal rules on paper, it is, in addition to quantitative cross-country studies, valuable to study the fiscal frameworks in individual countries. Due to the strong fiscal position in Sweden since 2000, the Swedish experience can be interesting in the debate on how fiscal frameworks should be constructed. In the following section, we therefore describe the Swedish MTBF. We thereafter evaluate the framework and briefly discuss what constitutes an effective MTBF, and to what extent the Swedish MTBF corresponds to such a framework.

3 The Swedish MTBF

The MTBF is one part of the Swedish fiscal policy framework. It consists of a surplus target for *general* government, an expenditure ceiling for central government combined with a stringent top-down budget process, and a budget-balance requirement on local governments. The components of the framework are described in more detail in

Section 3.2-3.5 below. Section 3.1 gives a background to the framework.

3.1 Background

The main driving force behind Sweden's introduction of a MTBF was the economic crisis in 1992-94. Although the crisis was exacerbated by an international downturn, its causes were primarily domestic. In response to the crisis, Sweden's monetary and budgetary frameworks were thoroughly reformed. In the autumn of 1992, speculation against the krona, encouraged by earlier series of devaluations, forced the Swedish Central Bank (The Riksbank) to abandon the fixed exchange rate regime, whereupon the TCW exchange rate fell 20 per cent. Responsibility for monetary policy, with price stability as its objective, was transferred to the Riksbank.[5]

Fiscal policy initially aimed at consolidating the public finances. A substantial consolidation programme (7.5 per cent of GDP) was successfully implemented in steps between 1995 and 1998. This programme lowered real demand in the short term but enhanced the public finances' long-term sustainability. This strengthened business and household confidence, which together with falling real interest rates and the weak currency's stimulation of export demand partly counteracted the consolidation programme's initial negative effects on domestic demand.

The implementation of the consolidation programme was accompanied by the adoption of a new, firmer top-down budget process, including the introduction of multiannual nominal expenditure ceilings from 1997 and onwards. In 1997 it was also decided that a general government surplus target of 2 per cent of GDP over the cycle would be implemented in steps between 1997 and 2000. In addition, to strengthen the public finances at the local level (and to increase the probability of the surplus target being met for the general government sector as a whole), from 2000 local governments were required to plan for balanced annual budgets.

It is important to note that, to a large extent, Sweden's MTBF was introduced *after* the consolidation programme had been completed. While the MTBF is mainly intended to work as an anchor for future fiscal policy, at its introduction it was also a method for locking-in the fiscal adjustments that the consolidation programme had achieved. As pointed out by, for example, the IMF (2009), fiscal rules are more likely to be accepted when countries already have made some progress towards fiscal consolidation. One way of interpreting this is that when countries have recently experienced a fiscal crisis that necessitates fiscal consolidation, as in the Swedish case, political conviction that fiscal rules actually have a role to play may be stronger than otherwise.

3.2 The surplus target

The surplus target states that net lending shall be 1 per cent of GDP over a business cycle.[6] After proposal from the government, parliament made it mandatory by law for the government to present a medium-term target for net lending from August 1, 2010. The level of the target, however, is not subject to legislation.

The surplus target is to be met over a business cycle, which is intended to prevent a pro-cyclical fiscal policy. With an annual surplus as the target, fiscal policy would need to be contractive in a recession and vice versa; fiscal policy would then be pro-cyclical and not contribute to stabilisation of resource utilization.

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[5] The Riksbank was not made legally independent until 1999 but in practice it became independent when monetary policy was delegated to it in the early 1990s.

[6] The target was originally 2 per cent of GDP. After a decision by Eurostat that part of the old-age pension system savings should be accounted as private savings, the target was technically adjusted to 1 per cent from 2007.

Over the years, various arguments have been used to motivate the surplus target, and the attributed weight to each argument have varied. Debt reduction was emphasised in the early stages, followed later by demographic issues. In the 2010 Spring Budget Bill, the government clarified that the target should contribute to:

1) long-term sustainable public finances so that citizens, business and financial markets maintain confidence in fiscal policy;
2) keep sufficient buffer in place to meet major economic declines and enable an expansionary fiscal policy without causing substantial and sustained deficits in the public finances;
3) intergenerational equality. In Sweden, as in many other countries, the older segment of the population will increase sharply over the coming decades. During demographically favourable years, relatively high savings translates into reduced national debt. Such savings mean that larger generation groups can contribute to the financing of their future medical and care services, while also contributing to fairness between generations;
4) economic efficiency. By enhancing conditions that make it unnecessary to raise the tax ratio (as a consequence of the demographic development), a surplus target contributes to economic efficiency.

The government has emphasised that maintaining the long-term sustainability of public finances is a necessary condition for achieving the other motives for the surplus target. If public finances are not sustainable, financial markets and households lose confidence in the government's ability to meet its commitments. As a consequence, the focus of fiscal policy would have to shift from promoting higher growth, employment and welfare to reducing debt. This is evident not least from what happened in Sweden during, and after, the crisis in the early 1990s.

International experience from the current financial crisis shows that there are good reasons to ensure that a buffer exists for coping with severe economic downturns and avoiding an unsustainable increase in debt. Having room for fiscal manoeuvring in such situations enables a strong fiscal policy. Against this background, the Swedish government has declared that it attaches great importance to the stabilisation policy argument provided that long-term fiscal sustainability is maintained. Support for this comes from Leeper (2009), who stresses the importance of maintaining a risk-free fiscal policy, *i.e.*, a policy that ensures that the probability of the economy approaching its fiscal limit is negligible, so that investors do not demand a risk premium for holding the government's bonds. The financial markets' reactions differ between different types of countries. The ability to maintain surpluses in good years is likely to be particularly important for small open economies with their own currency and with large automatic stabilizers, like the Swedish economy. Haugh *et al.* (2009) present empirical evidence, which indicates that in times of global financial stress, such economies often are more vulnerable in terms of risk premia. If financial markets and households lack confidence in the sustainability of public finances, fiscal stabilisation measures will be less effective or even counterproductive.

Regarding the surplus target's contribution to intergenerational equality and economic efficiency, the government announced in the 2010 Spring Budget Bill that the target should be used only to manage the part of the increase in the proportion of elderly that is due to temporary changes, *i.e.*, that it should not be used to manage the continual increase in average life expectancy. It also emphasised that the surplus target should not be used to pre-fund any future demand for a higher quality of publically provided services.

It is reasonable to assume that the relative weights attached to the various motives will change over time. In the 2010 Spring Budget Bill, the government therefore declared that the motives behind the surplus target and its level should be reassessed at regular intervals. However, it was also emphasised that the overhauls shall not be used to justify deviations from targets.

When Sweden introduced the surplus target, there was very limited published analysis concerning the appropriate level of a such target. The level was chosen on the grounds that net debt would be eliminated in the coming 10 to15 years. When this was achieved already in 2001, the level remained unchanged. Recently, however, a government report presented such an analysis (Finansdepartementet, 2010a). Given the motives specified by the government, the report concluded that there are no strong reasons for changing the current level of 1 per cent. Moreover, it concluded that at present, there were no major conflicts between the different motives for the target.

3.3 The expenditure ceiling

The Swedish expenditure ceiling covers the primary expenditures of the central government together with expenditure of the old-age pension system. The ceiling is set by Parliament on the basis of a government proposal. The ceiling was used by the government on a voluntary basis up to 2010. From 2010, the government is required by law to propose an expenditure ceiling for year t+3 in the Budget Bill for year t+1 (presented in the autumn of year t). For example, in the Budget Bill for 2010 (presented in the autumn of 2009), the government proposed a ceiling for 2012. The government is obliged by law to take necessary measures to secure that actual expenditures do not exceed the ceiling. The *practice* is that once a ceiling has been set, it shall not be changed, unless that is technically motivated.[7] This secures a medium-term planning horizon. It is *possible* to change set ceilings for non-technical reasons, but this has only occurred twice and on both occasions the ceiling was lowered.[8]

The ceilings are set in nominal terms (thus they are not adjusted for inflation). Normally the ceiling therefore include a buffer that can be used for expenditure arising from unforeseen cyclical factors and inflation. This buffer is called the budgeting margin. The government's practice has been for the budgeting margin to be at least 3 per cent of forecast expenditure for year t+3, at least 2 per cent for year t+2, at least 1.5 per cent for year t+1 and at least 1 per cent for the current budget year.

The Swedish budget process is characterized by a top-down perspective (see Section 3.4). The expenditure ceiling is the overarching restriction on the budget process in terms of total expenditure. Throughout the process, from the setting of the ceiling to the completion of the budget year, it is necessary to prioritise between different areas of expenditure within a given space. In addition, the ceiling's medium-term perspective provides conditions whereby temporary increases in revenue (due, for example, to cyclical factors) are not used to finance permanently higher expenditure. This also limits the risk of pursuing a destabilising (pro-cyclical) fiscal policy on the expenditure side.

Consequently, the expenditure ceiling constitutes an important policy commitment that promotes budget discipline and strengthens economic policy's credibility. It improves the probability of achieving the surplus target and promotes long-term sustainable finances. The level of the ceilings should also promote a desirable long-term development of central government expenditure. Together with the surplus target, the ceilings are central for controlling the overall level of taxation, and help to avoid a situation in which poor expenditure control necessitates gradually higher taxes.

7 The limiting effect of the ceiling shall be the same over time. Adjustments *shall* therefore be done for "technical reasons", for instance if responsibility for an item of expenditure is transferred from central to local government without affecting the level of expenditure in the general public sector.

8 One may argue that the possibility of changing the set ceilings is a weakness of the framework. However, a *new* government must be able to choose a ceiling that is consistent with its priorities.

3.4 A stringent budget process

The top-down perspective in the Swedish budget process entails a procedure whereby different expenditure proposals are set against each other and spending has to be accommodated in the expenditure ceiling's and surplus target's predetermined limit on total expenditure.

In April the government submits a spring fiscal policy bill that describes the guidelines for fiscal policy, including an assessment of the suitable level of the expenditure ceiling in the end year in the forecast horizon. After parliament's decision on the spring fiscal policy bill the guidelines are transformed to a concrete budget proposal in September. The budget negotiations are hence concentrated to one occasion per year.

3.5 The budget process inside the government

The budget process starts with an forecast of expenditures for the different areas of expenditures and for the income side. The Ministry of Finance analyses these forecasts and makes an assessment on whether the forecasted development is consistent with the surplus target and expenditure ceilings. If not, proposals for budget strengthening are evolved. All ministries have a responsibility to deliver sufficient information to make priorities, but the Ministry of Finance coordinates this work, and is responsible for ensuring that the assessment is consistent for all expenditure areas.

The Minister of Finance has a strong position in the Swedish government. All proposals that has budgetary consequences must be cleared by the Ministry of Finance before they are announced. The Ministry of Finance is also responsible for that the budget proposal is consistent with the surplus target and the expenditure ceilings. At all points in the internal negotiations on the budget, the foundation for negotiations is a complete budget proposal. This means that negotiations are focused on prioritising between different areas of expenditures within the boundaries set by the surplus target and the expenditure ceiling. The Ministry of Finance also has the responsibility for setting guidelines for the budget process.

The guiding principle for expenditures is that increases shall be financed by an equivalent decrease in other expenditures. Furthermore, the financing of a reform must derive from a concrete measure and dynamic effects shall not be used to finance individual reforms (although the dynamic effects of all reforms are taken into account in the overall macro-economic forecast). The general rule is that all items are reported gross. Consequently, transactions cannot be hidden by reporting only net flows. Another important feature is "the completeness principle", meaning that every item which affects the public borrowing requirement will be included in the state budget. This results in a clear statement of government commitments and a better understanding of the state budget.

3.6 Parliament's processing of the budget

By law parliament's processing and resolution of the budget follows a distinct top-down perspective. The expenditures are presented under 27 headings. As a first step, Parliament decides on the spending plans for each of the 27 areas of expenditures and an estimate of the state budget revenues. In a second step, the various committees deal with appropriations for the expenditure items. Since the 27 expenditure areas have already been decided in the first step, they constitute a binding constraint in the second stage. It follows that, at this stage, an increased appropriation under one expenditure area has to be financed by a reduction of other appropriations in the same expenditure area. An important aspect of the Swedish budget process is that the government do not need a majority in parliament to vote for their budget proposal. The budget is passed unless a majority unites behind a different proposal. This makes it easier for a minority government to pass the budget through parliament since the opposition has to agree on one single proposal.

3.7 The budget-balance requirement on local governments

The local government sector in Sweden is responsible for roughly 45 per cent of the general public sector's expenditures. To strengthen the budgetary process at local level, local governments are required by law to budget for at least balance. A local government that reports a deficit *ex post* has to correct it within three years. The budget-balance requirement applies to the financial result net of extraordinary items. It accordingly follows a different accounting practice from that of the surplus target, which is defined in accordance with the standard for national accounts (ESA 95).

The local government balanced-budget requirement is a *minimum* requirement. The Swedish Local Government Act stipulates that municipalities and county councils shall also comply with principles of good financial management. Thus, their budgets shall also take into account future costs such as major pension undertakings. There is no explicit sanction mechanism in the event of non-compliance with the balance requirement (apart from the response from the electorate).

4 The performance of the Swedish medium-term budgetary framework

In this section we briefly evaluate the performance of the Swedish MTBF since 2000 with an emphasis on the period 2006-10, the latter period covering the current government's preceding term in office and the crisis years.

4.1 The surplus target

When evaluating the surplus target, it is necessary to consider that the target is to be reached as an average over a business cycle. The National Audit Office (2008) and the Fiscal Policy Council (2009) have criticised the formulation of the surplus target for being too imprecise for stringent monitoring. They have argued that the current lack of a definition of the business cycle may give the government too much freedom, and that, consequently, the surplus target may not be a binding constraint. The government's use of several indicators to follow up the target and the absence of specified corrective measures to deal with slippages from the target, have also been criticised.

When the surplus target was introduced, there were no clear principles for monitoring compliance. Such principles have been developed gradually (and also changed) over time. The required surplus is to be achieved *on average over the business cycle,* but the length of the business cycle is not specified either *ex ante* or *ex post*. In recent years, three indicators have been used to assess compliance: (i) a backward looking 10 year moving average of net lending,[9] (ii) a centred seven-year moving average of net lending, capturing the current budget year, the three preceding years, and three "forecast years" following the current budget year, and (iii) the structural budget balance.[10] *In theory*, the structural budget balance can be regarded as the most relevant indicator.

[9] Before the 2010 Spring Budget Bill the government instead used average net lending since 2000 (the year the surplus target was introduced).

[10] Structural net lending is actual net lending adjusted for the GDP gap times an elasticity of 0.55, plus corrections for one-off effects and extraordinary tax income from capital gains.

Table 2

Public Sector Net Lending and GDP Gap
(percent of GDP and potential GDP)

	06	07	08	09	10	11	12	13	14	15
Net lending	**2.2**	**3.6**	**2.2**	**–0.9**	**–0.3**	**0.3**	**1.8**	**2.8**	**3.6**	**4.4**
Average since 2000*	1.0	1.3	1.4	1.2	1.0					
cyclically adjusted**	1.1	1.2	1.3	1.4	1.3					
Seven-year indicator	1.0	1.1	1.2	1.2	1.3	1.3	1.6			
cyclically adjusted**	1.4	1.7	1.8	1.9	2.1	2.3	2.7			
Structural BB	0.8	1.1	1.8	3.0	1.9	1.4	2.2	2.9	3.6	4.5
GDP gap	**1.8**	**3.2**	**0.5**	**–6.7**	**–3.8**	**–1.9**	**–0.7**	**–0.1**	**0.1**	**0.0**
Average since 2000	–0.2	0.2	0.2	–0.5	–0.8					
Seven-year average	–0.6	–0.9	–1.1	–1.1	–1.4	–1.8				

* Ten-year indicator from 2010.
** The indicator has been cyclically adjusted by the average GDP gap for the relevant time period times a budget elasticity of 0.55.
Source: Ministry of Finance.

However, measuring the structural budget balance is a highly uncertain matter, which is why, in its evaluation of the surplus target, the government uses several indicators.[11]

The first indicator has been used for retrospective evaluation. The "seven year moving average indicator" has been used as a forward-looking indicator "with memory". Although the retrospective indicator does cover many years, there is no guarantee that the average GDP gap in the relevant period is zero. The probability of the average GDP gap being non-zero is even higher for the seven-year moving average indicator. In the evaluation of these indicators, the government therefore takes into account the average GDP gap in the relevant periods. If the retrospective indicator, and the seven-year moving average indicator are both close to 1 over the relevant periods at the same time as the GDP gap on average is close to zero, those indicators indicate compliance. The structural budget balance is used to measure compliance in individual years. For compliance, the structural budget balance should be close to 1 per cent of GDP each year, unless discretionary stabilisation policy measures are warranted. For example, in a severe economic slowdown, the structural budget balance is allowed to (and should) be smaller than 1 per cent of GDP.

The practice has been that, given the values of the three indicators, the government makes an *overall* assessment of compliance, in which allowance is also made for the uncertainty of the assessment and the risk scenario; among other things, the risk of an asymmetric business cycle.

Table 2 shows the three indicators for 2006 to 2014. The most recent year with a final outcome is 2010. The backward looking ten year average is used for *ex post* evaluation. From 2001 to 2010, net lending averaged 1.0 per cent of GDP. If the 10 year average is adjusted for the GDP gap, the average is 1.3 per cent of GDP. The average net lending since 2000 (as well as the

[11] In can be interesting to note that this is analogous to the Riksbank's use of several measures of inflation. Se Boije *et al.* (2010) for a discussion on the pros and cons of the governments method to evaluate the surplus target.

Table 3

Expenditure Ceiling and Budgeting Margin
(billions of SEK)

	00	01	02	03	04	05	06	07	08	09	10
Expenditure ceiling	765	791	812	822	858	870	907	938	957	989	1024
Budget margin	5.0	4.7	0.4	2.9	2.4	5.7	11.8	27.9	13.6	24.4	38.5
percent of expenditure below the ceiling	0.7	0.6	0.0	0.4	0.3	0.7	1.3	3.1	1.4	2.5	3.9

Source: Ministry of Finance.

cyclically-adjusted figure) has, from 2006 and onwards, been at or above 1 per cent of GDP. This indicates that net lending has been somewhat above the surplus target during this period. Considered that fiscal policy always is forward looking and based on uncertain forecasts, this deviation from the target is not remarkably large.

The seven-year moving average indicator is forecasted to be at or slightly above 1 per cent of GDP for 2006-12. The cyclically-adjusted seven-year indicator on the other hand indicates a surplus substantially above the target. The structural budget balance is assessed to be above 1 per cent for all years except for 2006. In 2012-15, on average, net lending is forecasted to be substantially above 1 per cent of GDP. Based on these indicators the government's assessment in the 2011 Spring Budget Bill was that savings would be above the surplus target up to 2015, and that there therefore is a future scope for unfinanced measures. Due to the large uncertainty in the economic development over the coming years, the government did, however, emphasise that unfinanced measures should be undertaken only when it was certain that net lending would return to surplus.

This simple exercise does not prove that the surplus target has been a strictly binding restriction *ex ante* but it does show that the surplus target, *ex post*, has been respected over the years 2000-2010 and that, with current forecasts, it also is to be respected the coming years.

4.2 *The expenditure ceiling*

Table 3 shows that the expenditure ceiling has been respected in every year since 2000. It is also clear from the table that in some years the budgeting margin has been very small. During the period 2000-05, the (*ex post*) budgeting margin never exceeded 1 per cent of expenditures. In the past four years, the budgeting margin, on average, has exceeded 2 per cent of expenditures.

Both the National Audit Office (2008) and the Swedish Fiscal Policy Council (2009) have criticised the government for using "creative" accounting a number of times to avoid the ceiling to be exceeded; for example, expenditures have either been booked on the income side of the budget in the form of tax deductions (so called tax expenditures) or transferred from one year to another when the first year's margin under the ceiling was becoming too narrow.[12] This has occurred both under the current and the former government. For example the government transferred a payment to the municipalities of 7 billions SEK from 2010 to 2009 when the margin under the ceiling 2010

[12] For further discussion on this and other points of criticism on the use of the expenditure ceiling, see Boije *et al.* (2010).

Table 4

Net Lending and Result for the Local Government Secto
(billions of SEK)

	00	01	02	03	04	05	06	07	08	09	10
Net lending	1.5	–5.8	–14.5	–8.9	0.9	11.8	3.8	3.5	–3.6	–8.6	1.7
percent of GDP	0.1	–0.2	–0.6	–0.3	0.0	0.4	0.1	0.1	–0.1	–0.3	0.1
Result	1.4	1.3	–7.1	–0.8	2.2	13.3	15.2	14.1	7.9	13.3	19.1
percent of GDP	0.1	0.1	–0.3	0.0	0.1	0.5	0.5	0.5	0.2	0.4	0.6

Source: Ministry of Finance.

was forecasted to be very small. In some of these cases the government has presented these operations to the parliament in a transparent way, in other cases the government has failed to do so.

4.3 The balanced-budget requirement on local governments

Table 4 shows that, except for the years 2002-03, the local government sector as a whole has had a positive result. The general perception is that the balanced-budget requirement has contributed to a significant improvement in local government finances.

Although the balanced-budget requirement has contributed to improved finances for the local public sector, it has been criticised for contributing to a pro-cyclical policy at the local level. Since the municipalities and county councils are required to plan for balanced budgets each year, there is an obvious risk that they reduce expenditure when tax revenue falls in years with low capacity utilization and vice versa. The government has acknowledged this problem and recently appointed a committee to propose how this problem can be handled (subject to the restriction that the proposal shall not weaken the fiscal position of municipalities and county councils). Among potential solutions, the committee will analyse a mandatory “rainy day” fund to which municipalities and county councils would be obliged to contribute in “good” years, and from which they would receive payments in “bad” years.

4.4 Is it the framework or is it the Swedes?

As described above, Sweden generally has adhered to the MTBF both before and during the crisis. Is this a result of the construction of the framework or a result of that the framework has been operated by the Swedes? Our view is that well designed rules and budget procedures are important, but that strong political commitment is necessary for the MTBF to be effective. A well-constructed framework will not have the desired effect in the absence of political commitment to the framework. In Sweden, there is almost consensus among the political parties that the MTBF is an valuable fiscal policy tool, although there have been some disagreement regarding to what extent the framework should be binding by law.[13] The support for the framework derive from the experiences of the consolidation of the public finances after the fiscal crisis in the 1990s. This fiscally distressing period established an aversion to deficits, both among policy makers and the

[13] The exception is the left-wing party that is critical of many parts of the framework.

public. The fact that there have been no major deviations from the MTBF since it was established, has also created a "good" path dependence where deviations from the framework are politically costly.

5 What constitutes an effective MTBF?

In this section, we briefly discuss what constitutes an effective MTBF and to what extent the Swedish MTBF corresponds to such a framework. The economic literature does not provide any clear-cut answer as to what constitutes an effective MTBF. Some insights can although be drawn from the empirical literature:[14]

1) balanced-budget rules and debt rules contributes to better budgetary outcomes. For expenditure rules, an impact is found mainly in terms of restraining primary spending;
2) balanced-budget rules are more effective when they are combined with expenditure rules;
3) budget processes with a clear top-down perspective contribute to better fiscal performance;
4) fiscal councils enhance the effectiveness of fiscal rules;
5) transparent fiscal policies improve budgetary outcomes;
6) a strong legal foundation for rules and strict enforcement have a beneficial impact on fiscal performance.

On the whole, these empirical results support the construction of the Swedish MTBF. The first four points clearly correspond to the features of the Swedish framework. Regarding transparency, our assessment is that there has been a considerable improvement in recent years, but that the framework has a potential to improve further (see Section 6). The recent steps by parliament to make the use of the surplus target and the expenditure ceiling mandatory in a new budget law that regulates the budget process are in line with the first part of point 6.

Enforcement procedures should, according to the IMF (2009), rely on mandating corrective action and/or mechanisms that maximize the reputational cost of not taking action. Germany and Switzerland are examples of countries that use the first approach, while Sweden uses the second. A number of agencies participate in the external monitoring, for example, the Fiscal Policy Council, the National Financial Management Authority, the National Institute of Economic Research and the Audit Office. The Fiscal Policy Council, established by the government in 2007, has a special role in the monitoring of fiscal policy.[15] The council's main tasks is to assess whether fiscal policy is consistent with long-term sustainable public finances and the MTBF, especially the surplus target and the expenditure ceiling. Furthermore the council shall evaluate whether economic developments are in line with healthy long-run growth and sustainable high employment, evaluate fiscal policy in relation to the business cycle and examine the clarity of the stated grounds for economic policy and the motivations for policy proposals.

The Fiscal Council is formally an agency under the government, which appoints the eight members for a three-year period. The appointments are based on proposals from the Council itself. These proposals are made public, which means that the government's reputation is liable to suffer if it does not follow the proposals. It has so far followed the proposals of new members from the Council.

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[14] See Ayuso-i-Casals *et al.* (2008), Broesens and Wierts (2009), Debrun *et al.* (2009), Debrun *et al.* (2008), European Commission (2006), Holm-Hadulla *et al.* (2010), IMF (2009), Ljungman (2009) and OECD (2007).

[15] Debrun *et al.* (2009) show large effects of fiscal councils on budgetary outcomes.

It is likely that countries with a good public finance track record, where the memory of earlier fiscal crises has contributed to strong political support for the MTBF, can rely on reputational cost to a greater extent than other countries. It is also likely that this enables a more qualitative and flexible approach to the assessment of potential deviations from targets. However, *if* the memory of earlier fiscal crises fades and this gives rise to deliberate deviations from fiscal targets, it may be necessary, also in Sweden, to introduce a stronger corrective arm instead of just relying on reputational costs.

6 A Code of Conduct for fiscal policy

The past 20 years have brought significant progress in developing and describing the methods of monetary policy. This has been a major contributor to stabilising inflation at levels considerably lower than before. Even though there has been some progress has been made in developing and describing methods in fiscal policy, the gap to monetary policy in this aspect is still substantial.

Leeper (2009) has pointed to the large gains that could be achieved by, to a larger extent than today, anchoring fiscal expectations. The anchoring of fiscal expectations is important since economic agents need to form expectations on future policies to make economic decisions today regarding, for example, the appropriate level of investment. Central banks to a large extent communicate the information it possesses and thus helps the public to form its views about current and future states of the economy. To central banks, transparency is a means to enhance the effectiveness of monetary policy. Leeper (2009) argues that fiscal policy can learn from monetary policy in this aspect.

Although there are good reasons to increase fiscal policy transparency, and, in this work, learn from monetary policy, it is important to stress that there are important differences between fiscal and monetary policy, which necessarily means that the descriptions of the principles according to which each policy is conducted has to be significantly different. The decision-making process is much more complex for fiscal policy than for monetary policy, mainly due to that fiscal policy has a larger number of goals and available means than monetary policy. With this taken into consideration, there is still scope to improve communication on how fiscal policy is conducted.

The Swedish government has against this background recently increased fiscal policy transparency by presenting its fiscal policy framework in a special document aimed to work as a code of conduct for fiscal policy.[16] The purpose is not only to increase transparency, but also to strengthen the confidence for the public finances' long term sustainability. Another purpose is to through it comply with the (expected) requirements in the coming EU directive, setting minimum standards for national fiscal policy frameworks. The document is called "The Swedish Fiscal Policy Framework". It contains about 40 pages and is written in a non-technical manner. There are earlier examples of these kind of documents from the United Kingdom and New Zeeland. However, compared to these two examples, the Swedish document gives a more comprehensive description of how fiscal policy is conducted. Some inspiration to the description of the Swedish fiscal policy framework comes from the Riksbank's (2010) monetary policy strategy document. The Code of Conduct is to be seen as a steering-oar for fiscal policy. The Code itself says that if the government for some reason has deviated from the Code, it should motivate these deviations in the Spring Budget Bill (starting in 2012).

The Code of Conduct describes parts of the fiscal framework that are regulated in law, but also used practises and principles. Through the Code, the used practises and principles will be

[16] Government Offices (2011).

institutionalised. To keep the content of the Code updated, the intention is that it should be revised if there been major changes. If the Code is revised, the revisions must be clearly motivated in the new version of the Code.

6.1 Content of the Code

The Code includes the following six aspects of the fiscal framework:

1) the role of fiscal frameworks in fiscal policy making
2) the medium term budgetary framework (MTBF);
3) external evaluation;
4) stabilisation policy;
5) governmental interventions on financial markets;
6) openness and transparency.

The part of the Code that describes the role of fiscal frameworks in fiscal policymaking gives an account of the main targets for fiscal policy (not to be confused with the budgetary rules and targets). According to the Swedish Government, the main task of fiscal policy is to create the highest possible sustainable welfare by means of high sustainable growth and high sustainable employment (*the allocation target*), well-being for all (*the distributional target*) and economic stability (*the stabilisation target*). A prerequisite for achieving these targets is long-term fiscal sustainability. Since there are several goals for fiscal policy, it is inevitable that there will be conflicts between these goals. These conflicts must, of course, be handled by the elected politicians. In this complicated decision process, where the final decision often is a result of compromises, the Fiscal Policy Framework (as described by the Code of Conduct) work as a steering oar that promotes fiscal discipline and transparency.

The section in the Code covering the MTBF describes the different parts of the framework in a similar way as Section 4 above.

In the part of the Code covering External evaluation, the government emphasises the importance of "fiscal watchdogs", both at the international and national level. Since there is no formal enforcement procedure based on mandating corrective action in the Swedish Fiscal Policy Framework, external evaluation contributes to a high reputational cost of not taking action in case of slippages from the fiscal targets. At the international level, the EU, OECD and the IMF are examples of fiscal watchdogs, where the EU-commission surveillance is particularly important. The evaluation by the EU commission is expected to be intensified over the next coming years with the proposals discussed for a new EU economic governance. On the national level, there are also several governmental agencies that monitors different parts of fiscal policy, *i.e.*, the Swedish Audit Office, The national Institute of Economic Research and the Swedish Fiscal Policy Council. In the Code, the government clarifies that the Fiscal Policy Council has a special responsibility in this monitoring.

Regarding stabilisation policy, the Code describes the different roles for monetary and fiscal policy as well as principles for how fiscal policy is used for stabilisation of the economy. The Riksbank (monetary policy) is regarded to have the main responsibility for stabilisation policy as Sweden has a flexible exchange-rate. Fiscal policy contributes to stabilisation policy foremost through maintaining confidence for the sustainability of the public finances. During normal business cycle fluctuations, fiscal policy also contributes to stabilisation through the automatic stabilisers and semiautomatic stabilisers (*i.e.*, active labour market policies). When there are very large swings in the business cycle (due to large demand or supply shocks), fiscal policy also may need to support monetary policy and the automatic/semiautomatic stabilisers through discretionary measures. The Code says that if such discretionary measures are taken, they must be consistent with long-term sustainability of the public finances. Experience shows that many temporary measures often are difficult to reverse. The Code therefore stipulates that temporary measures that are difficult to reverse, should be avoided. If there is a scope for reforms, discretionary policies should instead focus on bringing forward structurally sound permanent measures.

The part of the Code covering governmental interventions on financial markets, describes the responsibilities of different governmental agencies as well as principles for governmental interventions. Even with good institutions, Sweden will not be immune to global financial crises. However, clearly defined mandates for different governmental agencies, as well as clear principles for governmental interventions in financial markets, are essential in preventing nationally induced financial crisis, and contribute to an effective handling of financial crises once they have occurred. In certain situations, governmental interventions can be motivated to prevent a financial system meltdown. The Code says that such interventions must be constructed in a way that minimises the long-term costs of the tax payers as well as moral hazard problems.

The part of the Code covering openness and transparency, describes principles for how fiscal policy is to be accounted for in the documents the government submits to parliament. It also provides general principles for forecasts and calculations of the effects of different reforms. For example, the Code stipulates that, if a reform is assumed to have significant economic effects, the government must reports its effects on GDP, employment and income distribution. The Code also stipulates that the government must present long-term sustainability calculations at least once a year.

7 Concluding remarks

In this paper, we have discussed, with reference to Swedish experience, how a well-designed fiscal policy framework can help to promote sound public finances. We have shown that the Swedish framework fulfils most of the criteria of what constitutes an effective framework. Furthermore, we have argued that the Swedish experience indicates that a fiscal policy framework can be essential for maintaining surpluses in good years. We have also shown that, on the whole, the framework has been respected. Our conclusion is that the framework has made a significant contribution to the enhancement of confidence in the long-term sustainability of public finances, which has kept risk premia small and enabled an effective stabilisation policy. We have also argued that the Swedish framework has contributed to Sweden, as one of a few European Union countries, being able, despite the financial crisis, to adhere to the SGP's numerical fiscal rules. This supports the view that national fiscal policy frameworks are likely to improve the performance of the SGP.

We have, however, also argued that a well-designed fiscal policy framework on paper is not a sufficient condition for fiscal sustainability and a responsible fiscal policy over the business cycle. Several countries, which prior to the crisis had a fiscal policy framework that ranked high *on paper,* performed badly during the financial crisis. For a fiscal policy framework to work properly, there must be a strong political belief that such frameworks actually matter, and a political commitment to respecting them. Such political commitment is likely to be stronger in countries, such as Sweden, with recent experience of fiscal crises. Seen from this perspective, in many countries today's fiscal crisis is likely to be a loud "wake-up call".

As recognised in the economic literature, there is a trade-off between fiscal rules that tie politicians to the mast, and rules that are sufficiently flexible to cope with changes in economic conditions. We have argued that countries with a good track record, where the memory of recent fiscal crises has contributed to strong political support for the fiscal policy framework, can rely on reputational cost to a greater extent than other countries. It is also likely that this allows a more qualitative and flexible approach to the assessment of potential deviations from targets. However, *if* the memory of earlier fiscal crises fades and this gives rise to deliberate deviations from fiscal targets, it may be necessary to introduce a stronger corrective arm.

Finally, we have described the content of the Swedish government's Code of Conduct for fiscal policy, which serves to institutionalise and strengthen the fiscal policy framework further. This Code does not only contain the MTBF, but also describes the main targets of fiscal policy, the importance of external evaluation, responsibilities and principles for stabilisation policy measures, principles for governmental interventions on financial markets, responsibilities of the different agencies involved, and principles for openness and transparency in the accounting of fiscal policy.

We hope that this paper – which has described the Swedish fiscal policy framework, its background, our mainly positive experiences and recent improvements of it – can serve as an inspiration to countries that are in the process of introducing a fiscal policy framework.

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