The Swedish Fiscal Policy Council

Swedish Fiscal Policy

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The idea of Fiscal Policy Councils (Committees)

- Offspring from the discussion, originating in the 1980s, on rules versus discretion (Kydland and Prescott)
- Monetary regime with an independent central bank
- Can the lessons in some form be applied to fiscal policy?

References

Von Hagen and Harden (1994)
Eichengreen, von Hagen and Harden (1995)
Wren-Lewis (1996, 2000, 2002)
Blinder (1997)
Ball (1997)
Business Council of Australia (1999)
Eichengreen, von Hagen and Hausmann (1999)
Seidman (2001)
Wyplosz (2002, 2005, 2008)
Swedish Government Commission on Stabilisation Policy in the Event of Membership in the Monetary Union (2002)
EEAG (2003, 2004, 2006)
Calmfors (2003a,b, 2005)
Borg (2003)
HM Treasury (2003, 2004)
European Commission (2004)
Jonung and Larch (2004)
Annett, Decressin and Deppler (2005)
IMF (2005)

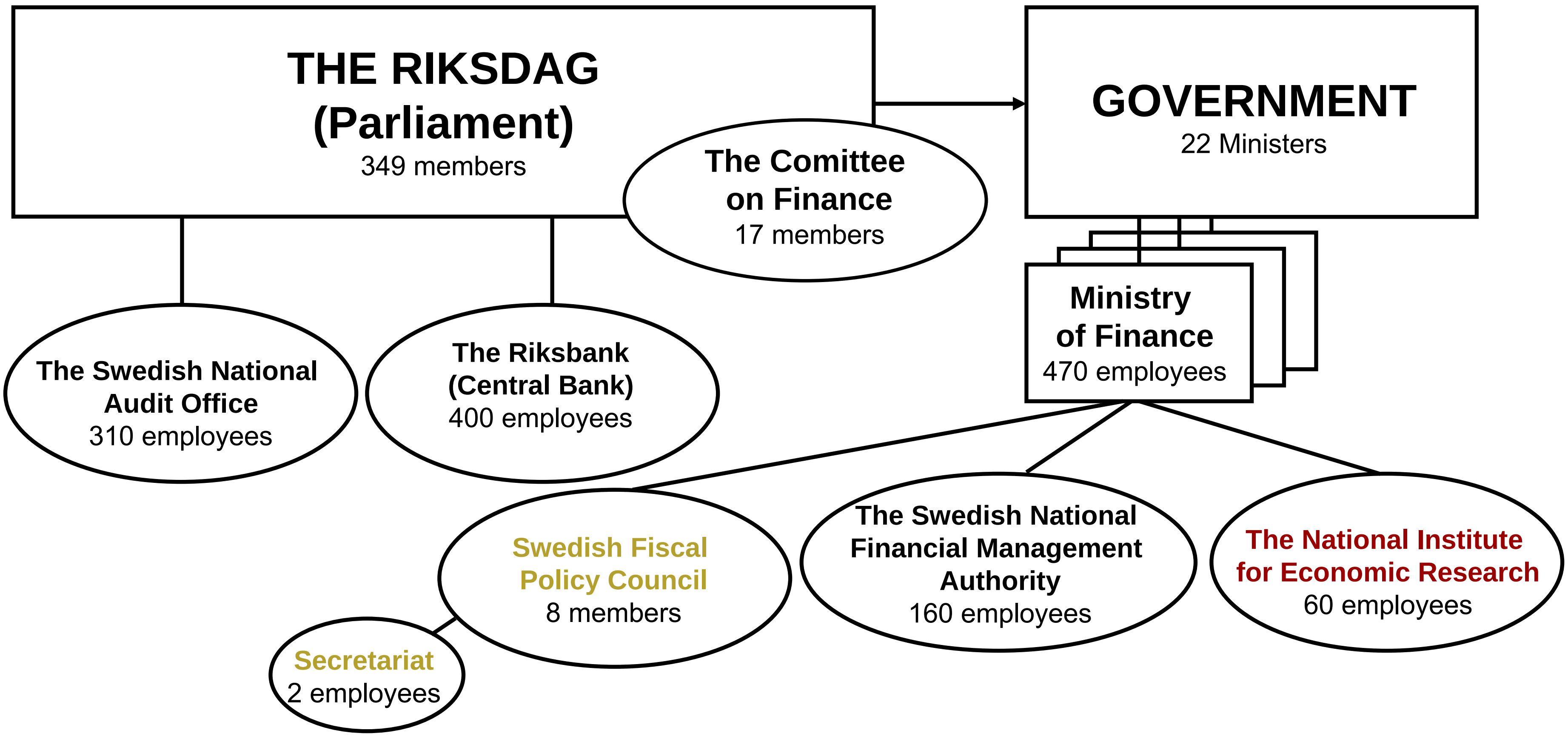
Ecofin Council

” ”national institutions could play a more prominent role in budgetary surveillance to strengthen national ownership through national public opinion and complement the economic and policy analysis at the EU level”

Different approaches to Fiscal Policy Councils

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

Sweden: ex post evaluation, not ex ante evaluation



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The tasks of the Fiscal Policy Council

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

To contribute to a better economic policy discussion in general

- Annual report: this year 15 May
- More information on www.finanspolitiskaradet.se

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The Swedish Fiscal Policy Council

Lars Calmfors, Stockholm University (Chair)

Torben Andersen, University of Aarhus (Vice chair)

Karolina Ekholm, Stockholm University

Per-Ola Eriksson, County governor, former Chair of the Parliament´s Finance Committee

Martin Flodén, Stockholm School of Economics

Laura Hartman, Office of Labour Market Policy Evaluation

Ann-Sofie Kolm, Stockholm University

Erik Åsbrink, former Minister for Finance

Swedish Fiscal Policy 2008: An Overview

1. Fiscal policy and the fiscal policy framework
2. Macroeconomic forecasts by the Ministry of Finance
3. Employment policy
4. Reforms in capital and real-estate taxation
5. The government’s basis for decision-making (memos, models and data)

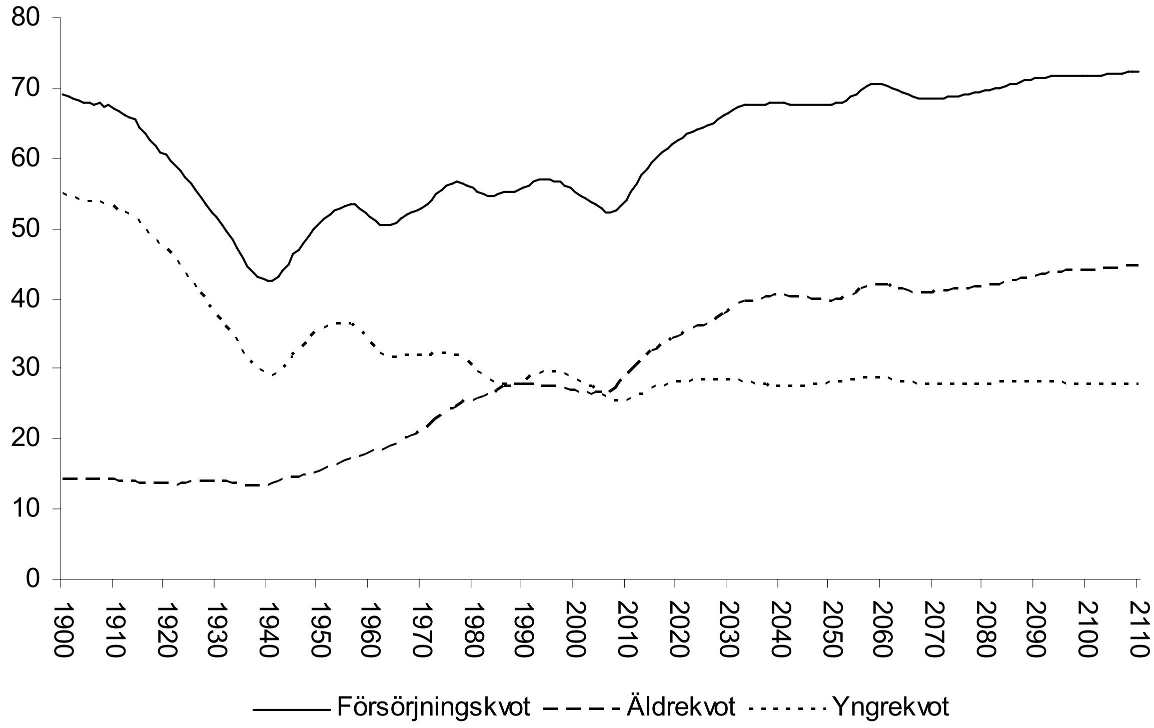
The main conclusions

- Correct to budget large surpluses for the next few years
- But the government should consider reformulating the surplus target
- Reducing the level of unemployment benefits and lowering the tax on earned income should increase employment in the long term
- But the financing reform of unemployment insurance and the real-estate tax reform are failures

The fiscal policy framework in Sweden

- **Long-run sustainability of fiscal policy** is the basic objective
- **The surplus target** (1 percent of GDP over the business cycle) and the **expenditure ceiling** for central government are medium-term, intermediate goals which should facilitate achieving the basic sustainability objective
- The level of the surplus target should be determined by:
  - goals for the redistribution of welfare among generations
  - goals for efficiency (tax smoothing)
  - precautionary motive
- Expenditure pressures due to the **demographic developments**

Försörjningskvot, äldrekvot och yngrekvot (procent)



Anm: Försörjningskvoten anger antalet personer 0-14 år och 65 år och äldre som andel av antalet personer 15-64 år. Äldrekvoten anger antalet personer som är 65 år och äldre som andel av antalet personer 15-64 år, medan yngrekvoten anger antalet personer 0-14 år som andel av antalet personer 15-64 år.
Källa: SCB.

The government should provide better motivations for the level of the surplus target

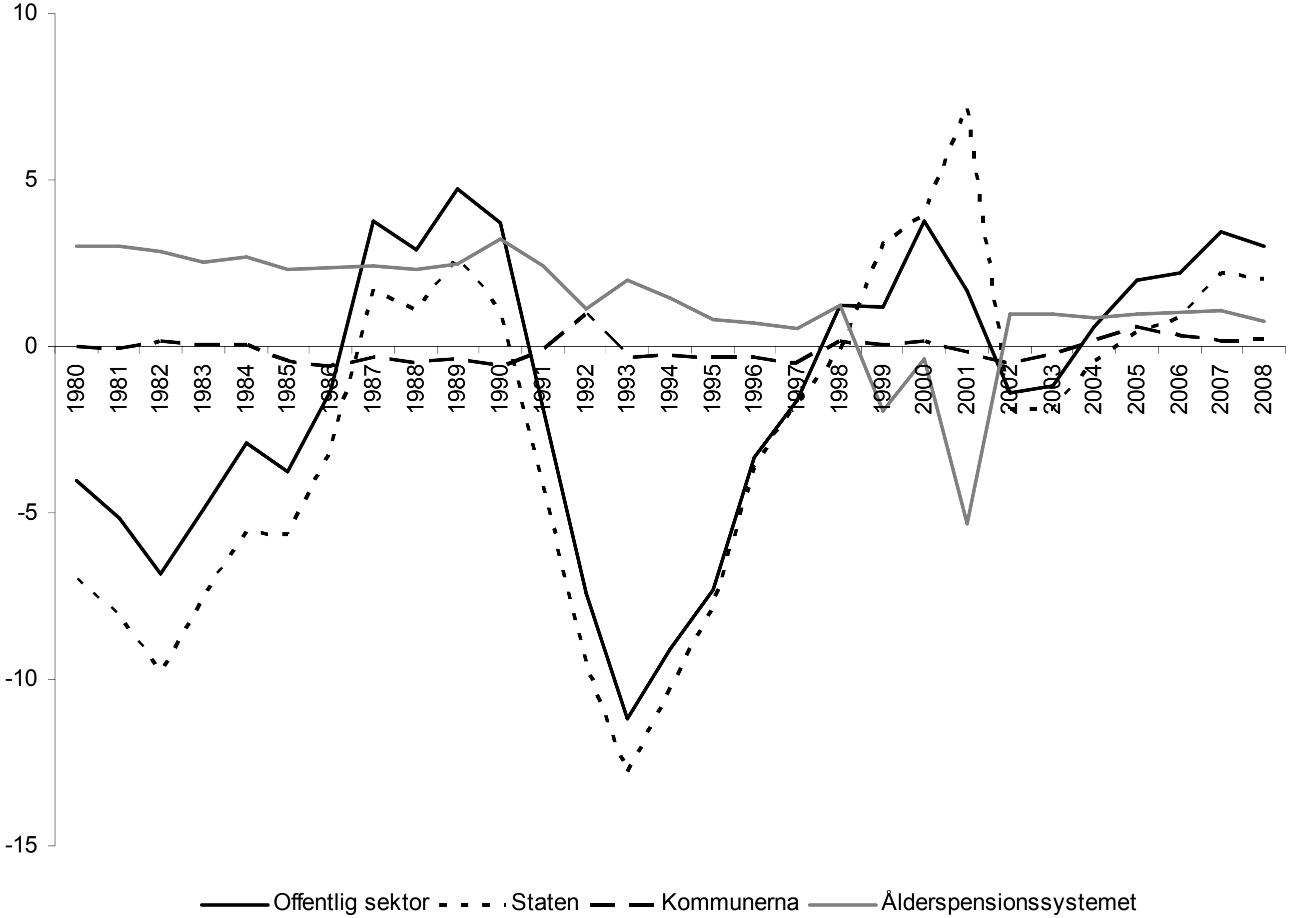
- The relative weights of different motives?
- Discussion of goal conflicts
- Need for **generational accounting**

  - how do various budget outcomes affect the distribution of welfare among generations?

Need for revisions of the surplus target

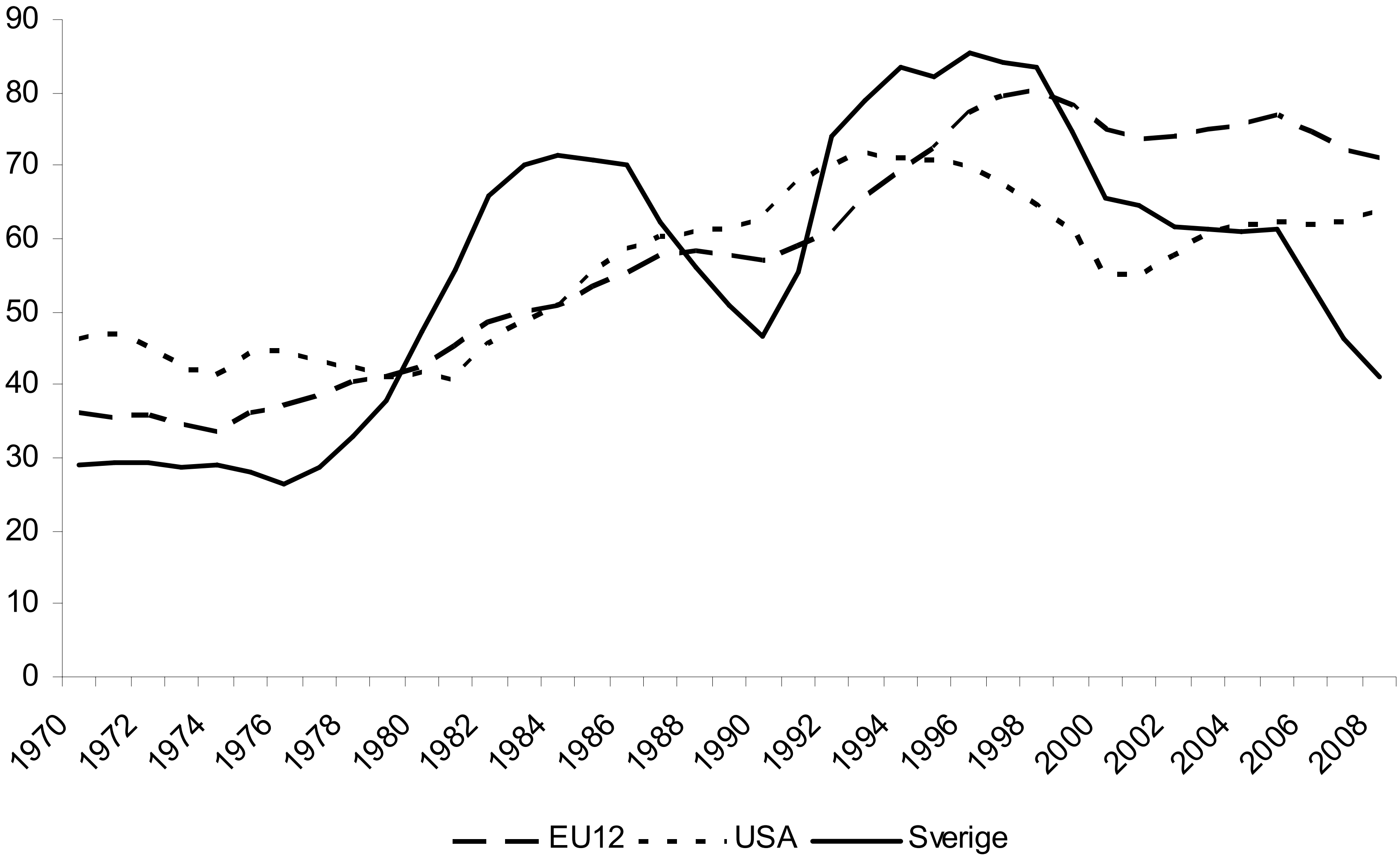
- According to the government´s own sustainability calculations it applies only until 2015
- According to the calculations the surpluses fall after that and eventually turn into deficits
- The surplus target was introduced in 1997 as part of the consolidation process after the earlier fiscal crisis
- Larger possibilities to fine tune the target today
- Also need for that if the legitimacy of the target is to be maintained

General government net lending and its parts (percent of GDP)



Source: National Institute of Economic Research

Consolidated general government gross-debt (percent of GDP)



Source: OECD Economic Outlook 2007/2

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Consider a Golden rule

- **Consider whether the surplus target should concern public sector total savings and not just net lending**

  - total savings is the sum of net lending and net investment

  - this is the same as a surplus target for current incomes and expenditures (a ”driftbudget”)

  - the surplus target can discourage public investment

- **Appoint a government commission**

  - theoretical adequacy versus verifiability

  - all invesments or only those that provide a pecuniary return?

  - strict rules against possible abuse

  - where to draw the line?

  - lower bound for the public sector´s **financial** wealth

Golden rule mathematics

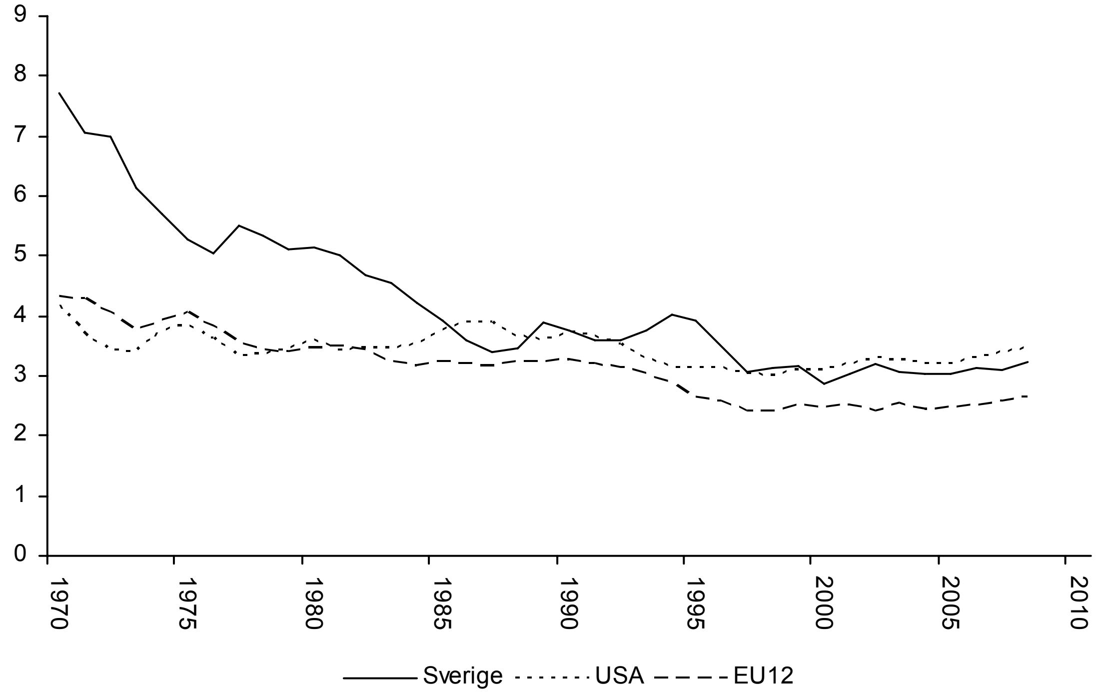
$$F = T - G - I \qquad (1)$$

$$I = N + D \qquad (2)$$

(1) can be rewritten:

$$S = F + N = T - (G + D)$$

Public sector gross investment i Sweden, EU12 and USA (percent of GDP)



Anm: Data för 2007-2008 är prognoser. Data för EU12 före 1991 är exklusive tidigare Östtyskland.
Källa: OECD Economic Outlook 2007/2.

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Examples of a golden rule

- UK
- Germany
- Many American states
- Swedish municipalities and regions
- Central government in Sweden in the 1950s
  - **”driftbudget”** for current expenditures and incomes
  - **”kapitalbudget”** for investment (loan financing)

Improve the accounting of the public sector economic position

- No reporting in the budget bills of public sector total wealth (including the capital stock)
- Impossible to get a complete view of the economic position of the public sector
- Wealth position reported only in the Annual accounts of the central government
- Add information on public sector total net wealth in next budget bill

Public sector financial position and wealth (percent of GDP)

Anm: Data för 2007–2008 är prognoser.
Källa: Konjunkturinstitutet.

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Mathematics of debt accumulation

- $b_t - b_{t-1} = f_t - g_t \cdot b_{t-1}/(1+g_t)$
- $b = f \cdot (1+g)/g$
- b = 0,01·(1,05)/0,05 = 21 percent

- With annual nominal growth of 5 percent (2 percent inflation and 3 percent real growth), the growth factor tends to reduce the net financial wealth ratio by approximately 0,05 · *20* percent of GDP = 1 percent of GDP
- Hence a surplus of 1 percent of GDP is required to keep the financial wealth at 20 percent of GDP
- An increase of the net financial wealth ratio requires larger surpluses

Decomposition of the change in general government financial net wealth (annual average change in percent of GDP)

	1993-1997	1997-2001	2001-2006
Change in net financial wealth	-3,3	5,8	3,3
Net lending	-5,3	2,0	0,4
Growth factor	1,0	0,8	0,1
Residual	1,1	3,1	2,8

Source: Statistics Sweden, National Institute of Economic Research and Swedish Fiscal Policy Council

Monitoring of the surplus target

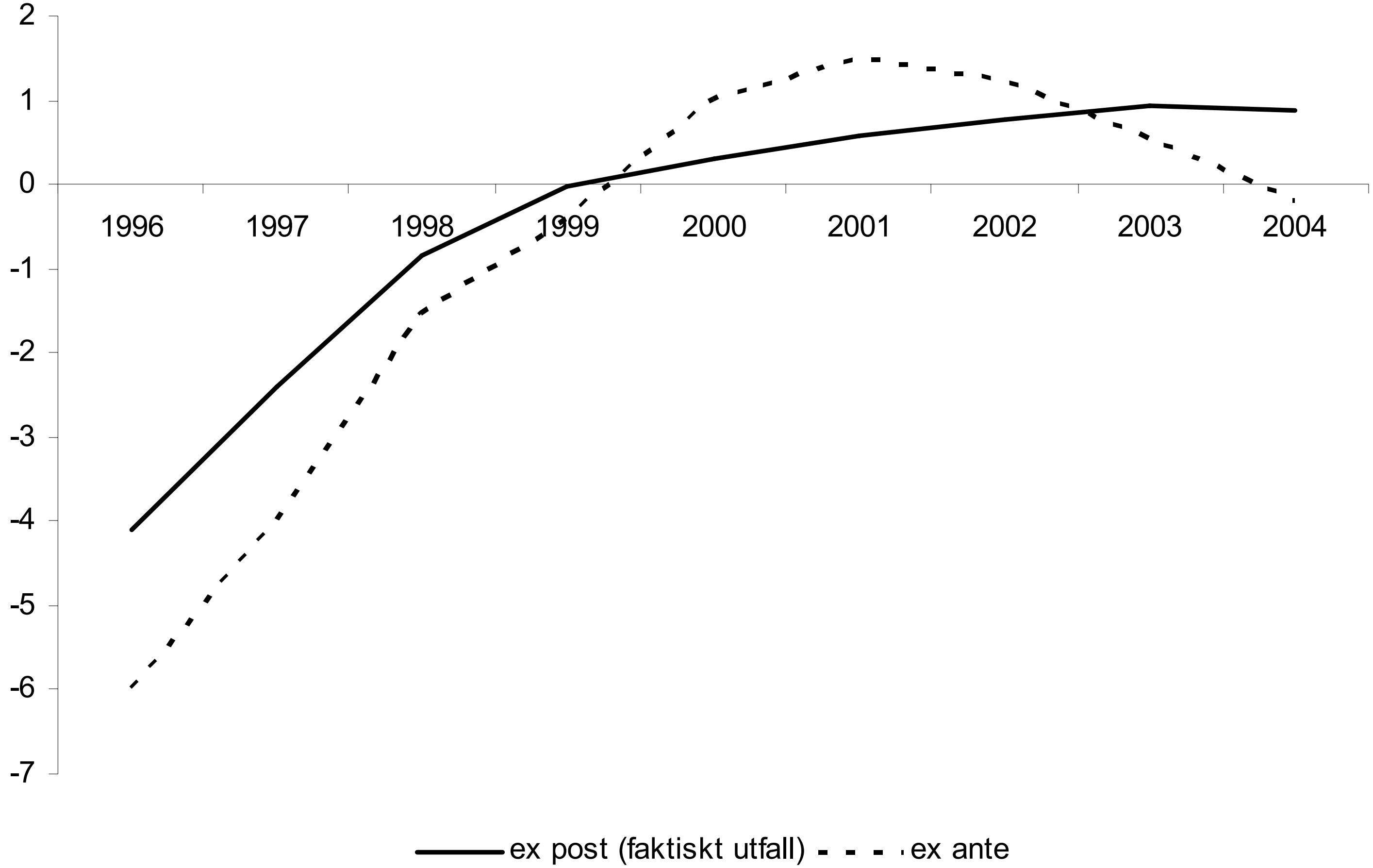
- Surplus of one percent of GDP over the business cycle
- Earlier criticism: what is the length of the cycle?

<u>Three indicators</u>

1. Historical average from 2000
2. Moving seven-year average centered on current year (forercasts for four years)
3. Structural budget balance

- Discretionary judgements regarding cyclical situation
- Need for exogenous (independent forecasts)
- Unclear how policy will react to different signals from the indicators

Moving average indicator for general government net lending (percent of GDP)



Source: Ministry of Finance and National Institute for Economic Research

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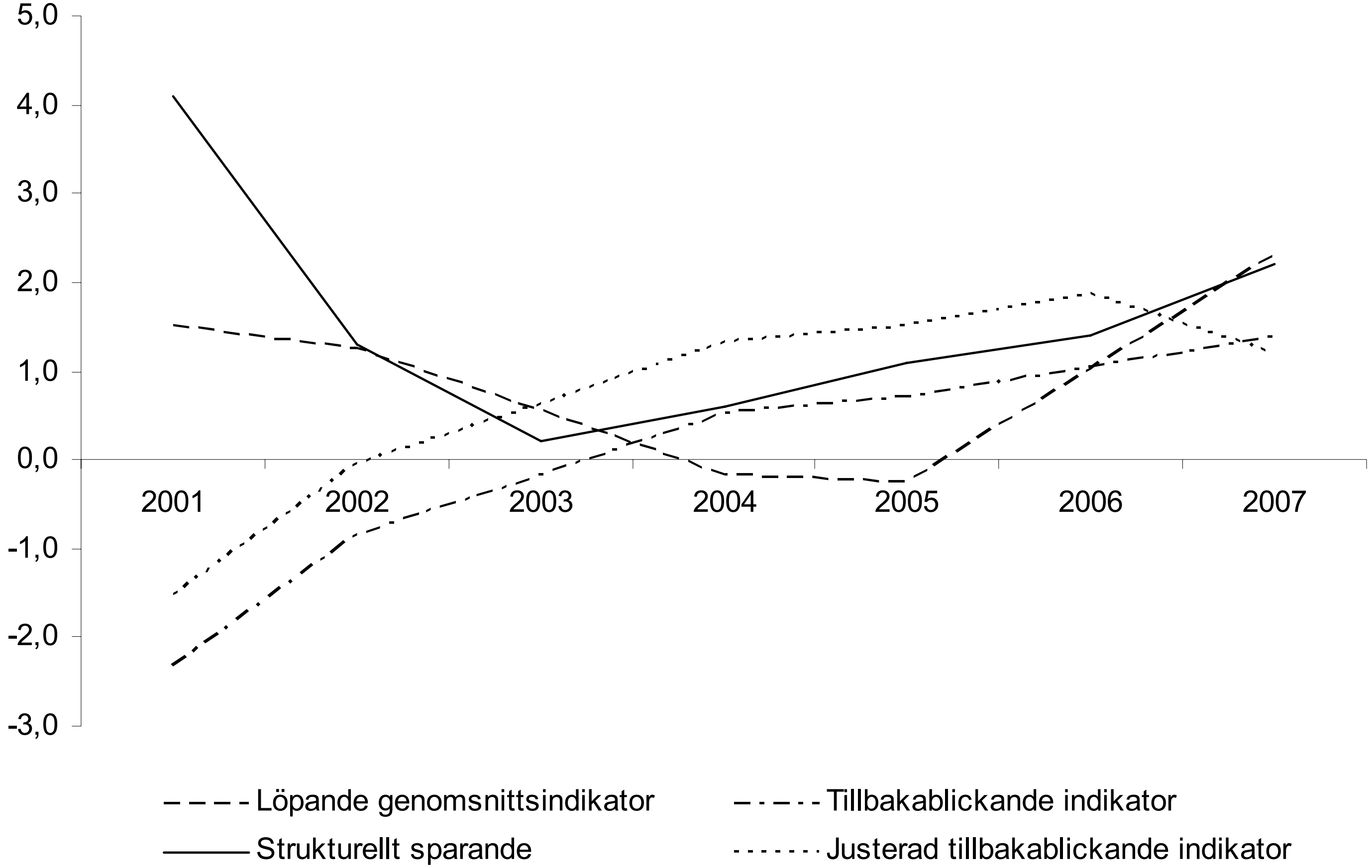
Different indicators for general government net lending (percent of GDP)



Source: Ministry of Finance and National Institute for Economic Research

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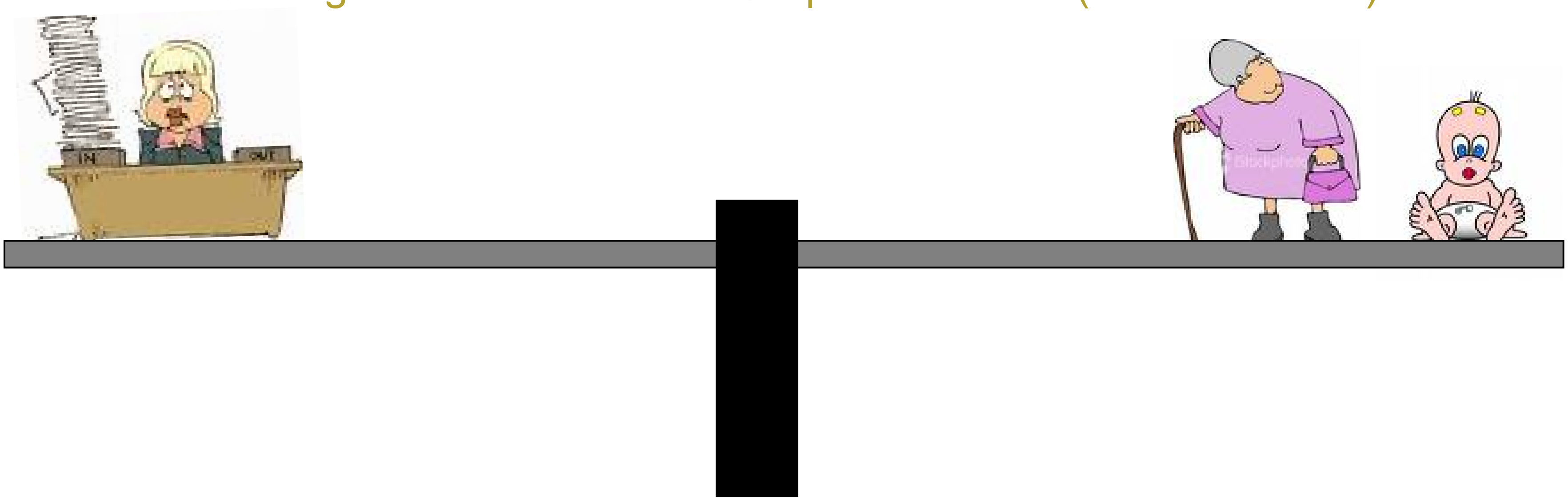
Sustainability

present discounted value of income
= initial net debt + present discounted value of expenditures

S2=0

S2 negative → tax reduction/expenditure rise (and vice versa)



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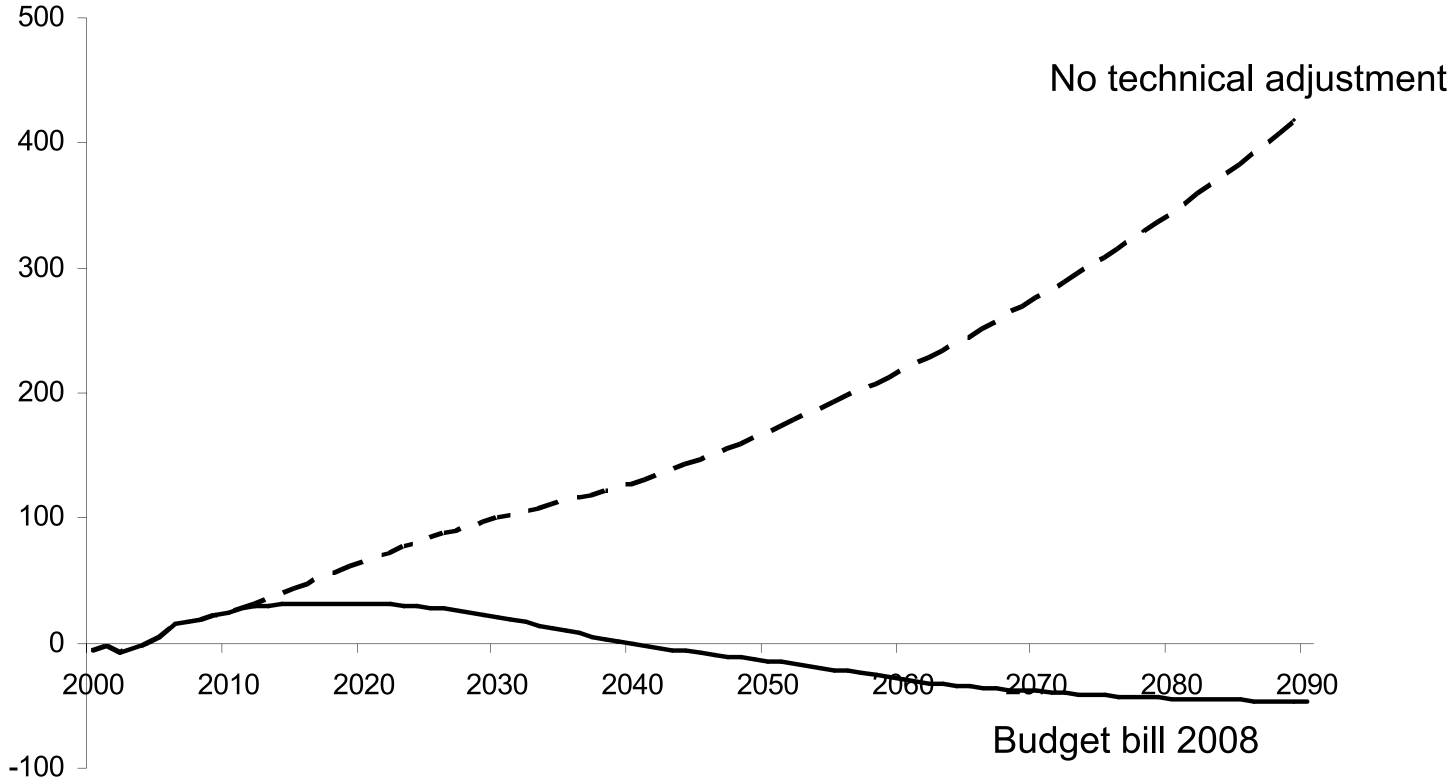
Calculations by the Ministry of Finance

- Tax rules and spending policies are held constant and demography determines development
- Fiscal policy is sustainable since **S2=0**
- Pension reform of 1999/2000 reduced pension liabilities
- Transparency:
  - Increase in expenditures from 2011 and onward by 5 percent of GDP through a **technical adjustment**
  - Model is poorly documented
  - Not much in terms of sensitivity analysis

Public sector financial net wealth (percent of GDP)



Source: Ministry of Finance and the Swedish Fiscal Policy Council

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Sustainability indicator and implicit surplus target (percent of GDP)

	S2 år 2009	Smallest sustainable net lending 2009-2015
Budget Bill 2008	0,1	-
Budget Bill without technical adjustment	*-3,8*	*-0,7*
Higher standard in public sector	-0,4	3,8
Higher standard in healthcare	-0,3	3,5
Larger effect of employment policy	-4,3	-1,1
Smaller effect of employment policy	-3,3	-0,5
Reduction in mean working hours	-2,1	1,4
Later retirement	-5,0	-2,0

Källa : Finanspolitiska rådet baserat på Finansdepartementets kalkyler i Budgetpropositionen för 2008.

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Wise to run large surpluses over the coming years

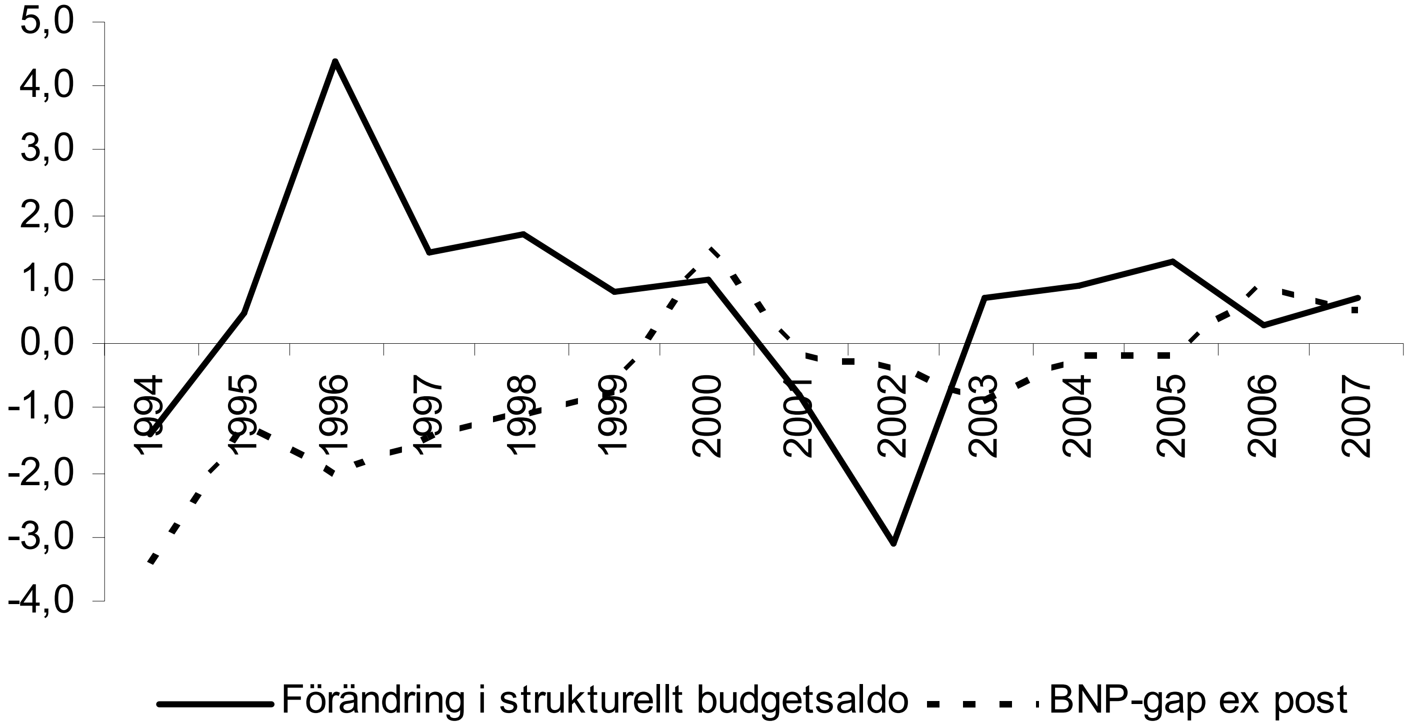
- Large surplus today
- Large uncertainty in sustainability calculations gives strong **precautionary** motive to have larger surplus than one percent of GDP until 2015
- Net lending at around one percent of GDP is exactly sufficient to keep financial wealth constant as a share of GDP (at 20 percent)
- How large **precautionary buffers** should be is a political question
- A natural adjustment is to increase the retirement age as longevity rises

Fiscal policy as a stabilisation policy tool

- Automatic stabilisers or discretionary fiscal policy
- Earlier: not very clear when discretionary fiscal policy should be used
- Latest budget bill: improvement
- Monetary policy and automatic stabilisers have main responsibility for stabilisation
- But there are situations in which discretionary fiscal policy should be used

  - supply-side shocks when inflation and the output gap move in opposite directions
- Our view: Need for more clear ex ante principles

Change in structural balance and ex-post level of GDP gap (percent of GDP)



Source: Ministry of Finance and National Institute for Economic Research

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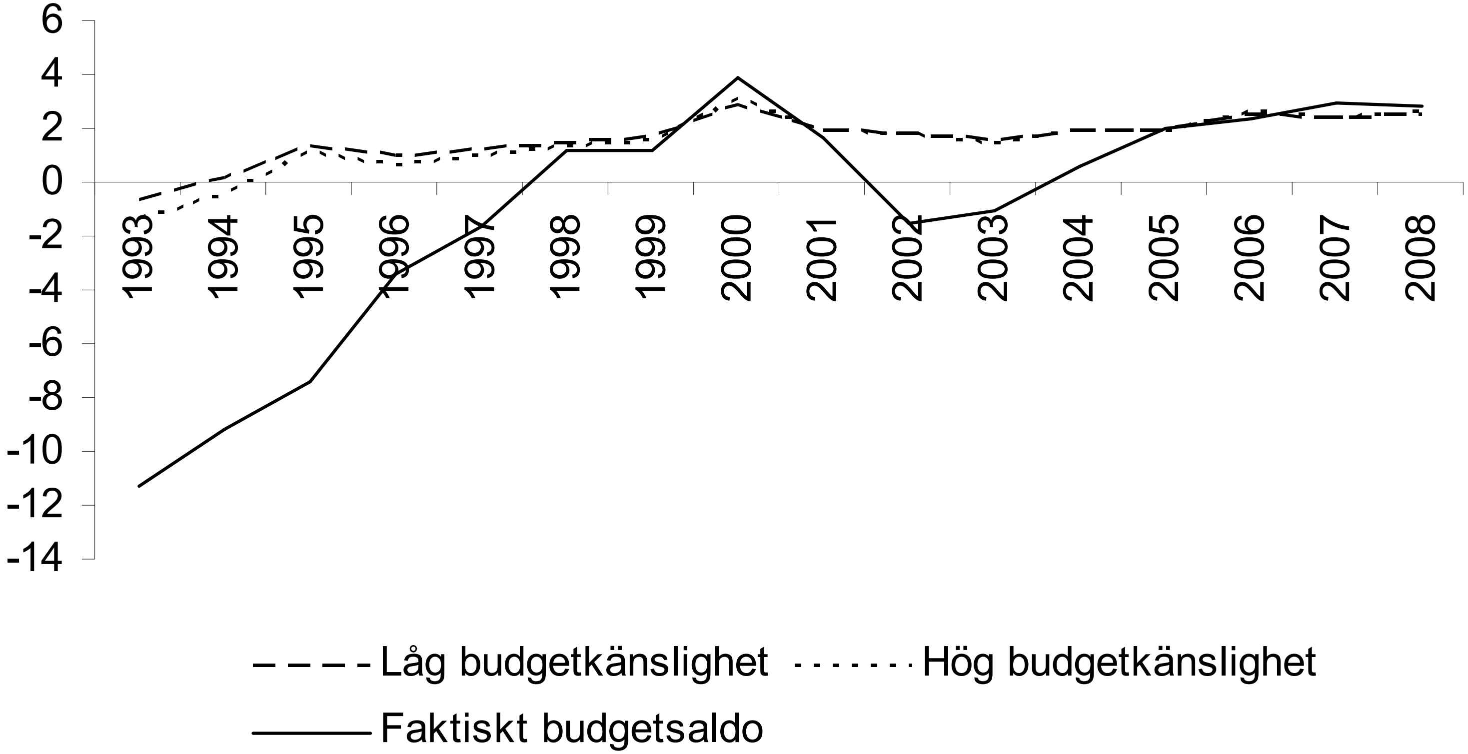
Actual and estimated net lending with a structural surplus of 2 percent of GDP (percent of GDP)



Source: Ministry of Finance

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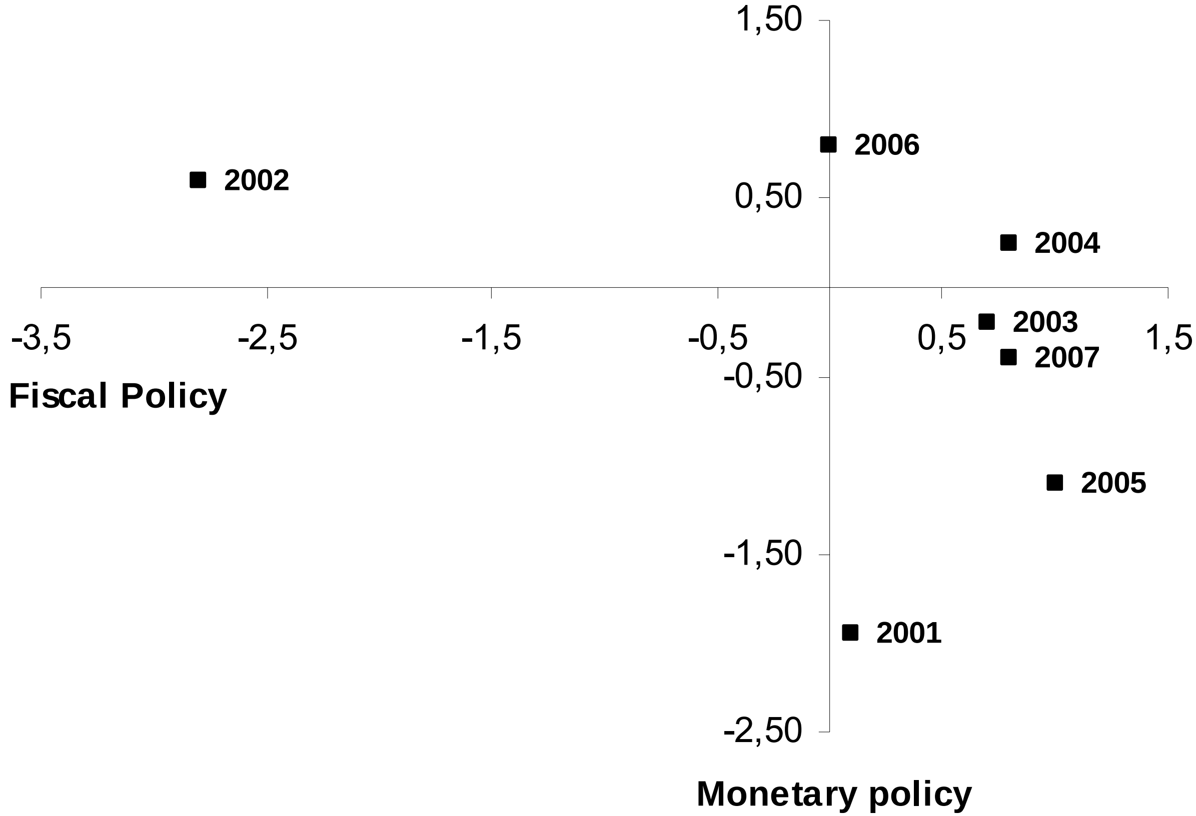
The stance of fiscal and monetary policy 2001-2007



Source: Ministry of Finance

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Criteria for use of discretionary fiscal policy

<u>Double requirements</u>

1. Large cyclical disturbances – output gap above 2 percent
2. Discretionary fiscal policy must be able to achieve something more than monetary policy can do (value added)

Value added of discretionary fiscal policy

1. Limits on interest rate policy
   - liquidity trap (zero interest rate bound)
2. Monetary policy cannot simultaneously achieve several goals
   - fear of asset price hikes
   - stagflation (fiscal policy does not depreciate the currency; supply-side effects)
   - targeting of non-tradables sectors
   - targeting of low-income groups
3. Uncertainty about the effects