VOX

What can Europe learn from Sweden? Four lessons for fiscal discipline

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Several Eurozone countries are currently struggling with acute fiscal crises. This column argues that Sweden provides an example that fiscal transparency and a high-quality economic policy debate may be more important for budget discipline than formally binding rules and automatic correction mechanisms as being envisaged in the European fiscal compact.

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Several Eurozone countries are currently struggling with acute fiscal crises (eg Corsetti and Müller 2012). At the same time, the new fiscal compact is an attempt to beef up fiscal frameworks for the future. In order to judge both the fiscal consolidation efforts and the reforms, comparisons with economies that have in the past carried through such processes successfully are helpful.

A prominent example is Sweden, which stands out among the EU countries for its strong public finances. At the trough of the recession in 2009, Sweden had a fiscal deficit of only 0.9% of GDP. In 2011, it even showed a small surplus. This is a stark contrast to the fiscal crisis that Sweden experienced in the 1990s. The lessons from Sweden are diverse. They show that a determined policy can indeed turn around the fiscal situation. But they also highlight that fiscal consolidation will be very painful in the Eurozone crisis countries and that the fiscal reforms underway may not be the optimal ones.

Lesson one: A deep fiscal crisis can create a consensus on fiscal discipline

In 1991-1993, Sweden experienced a severe macroeconomic crisis, its GDP falling for three consecutive years. The fiscal deficit was 11% of GDP in 1993. Consolidated government gross debt rose from 41% of GDP in 1990 to 73% in 1996.

The crisis led to the adoption of a tough fiscal consolidation programme. It was *unconditional*. A path was set out for the fiscal balance to be achieved that was irrespective of macroeconomic developments. Fiscal performance gradually improved. In 2000, a fiscal surplus of 3.6% of GDP was achieved. Continued budget discipline brought about a decline in government debt to 37% of GDP in 2011. Long-term government bond interest rates are now below those of Germany.

These developments are remarkable, as several factors thought to cause deficit bias have been present such as minority or coalition governments, strong polarisation between the left-wing and right-wing political blocs regarding the size of the public sector, and high employment as a political

priority (Calmfors and Wren-Lewis 2011). The explanation of the strong fiscal performance is that the 1990s fiscal crisis forged a broad political consensus that Sweden should never again end up in a similar situation.

Lesson two: Comprehensive fiscal reforms increase the chances of success

The consensus on budget discipline has been codified in a strict fiscal framework, the most characteristic feature of which is its comprehensiveness. The framework consists of five pillars:

- *A top-down budget process*. In a first step, overall government expenditure and its allocation between 27 areas are determined. In a second step, decisions are taken on individual expenditure items. In this phase, one type of expenditure cannot be raised unless another type of expenditure in the same area is correspondingly reduced.
- *A fiscal surplus target of 1% of GDP*. To preserve flexibility for fiscal policy as a stabilisation tool, the target does not apply in a single year but over a business cycle.
- *A ceiling for central government expenditure* set three years in advance.
- *A balanced budget requirement* for *local governments*.
- A reformed *pension system* designed to guarantee long-term sustainability as contributions, not benefits, are defined.

Lesson three: Fiscal transparency may be more important than formal enforcement

There exist no *formal* enforcement or sanction procedures. In contrast to the Swiss and German debt brakes and to what is envisaged in the European compact, there are no automatic correction mechanisms in the case of violations. Still, the rules have on the whole been respected. The system seems to rely on a high degree of *fiscal transparency* that provides the basis for a well-informed policy debate, thus raising the *reputation costs* for the government of deviating from its targets (Calmfors 2011). Sweden scores high in transparency indices based on the amount and quality of information produced by the government and on independent verification of this information (Lassen 2010; European Commission 2011).

The information given by the government includes regular follow-ups of the attainment of the fiscal targets and fiscal sustainability calculations. The Ministry of Finance also provides annually an evaluation of the scope for reforms (the total sum of discretionary tax cuts and government expenditure increases that the government can adopt and that are consistent with the surplus target) before the work on the budget starts. This calculation has in recent years also been accepted by the opposition parties.

The budget as well as the underlying forecasts and analyses are evaluated by several government agencies with a high degree of independence. The latest addition is the Fiscal Policy Council set up in 2007, with the remit to monitor the sustainability of the public finances, the adherence to the surplus target and the expenditure ceiling as well as fiscal policy's

cyclical stance. There are special provisions to safeguard the council's independence, such as a stipulation that the council itself proposes its members to the government.

The Swedish fiscal performance suggests that transparency and a high-quality economic policy debate might be more important for budget discipline than formally binding rules.

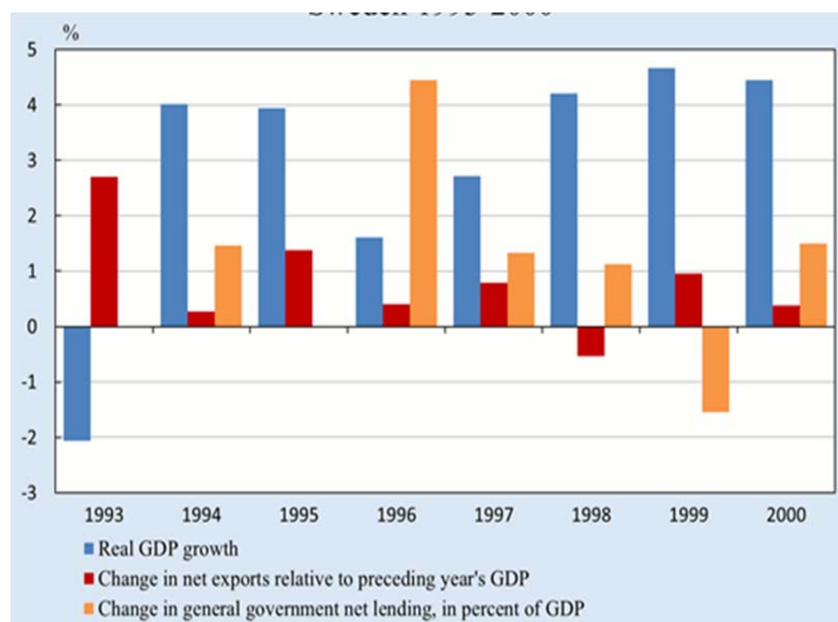
Lesson four: Output growth is crucial

A fourth lesson concerns the importance of output growth for fiscal consolidation. This holds both in the short and in the long run.

Sweden combined its fiscal consolidation in the 1990s with high output growth, an episode that has been cited as an example of an expansionary fiscal contraction (Giavazzi and Pagano 1996). This is a wrong inference (Fiscal Policy Council 2011). The Swedish economy grew because of a large *real exchange rate depreciation. I*n 1991-1993, relative unit labour costs fell by 20%. This was due mainly to a depreciation of the *nominal* exchange rate. The result was a boost to net exports (see the diagram). The stimulus effects from that, including second-round multiplier effects, allowed aggregate demand to grow in 1994-2000 despite the fiscal consolidation.

The exchange rate depreciation in the early 1990s kick-started the economy, greatly facilitating the fiscal consolidation. But there was also a long-term rise in the growth rate. In 1995-2011, the average annual GDP growth rate was 0.8 percentage points higher than the 1970-1994 average. Growth-enhancing reforms likely contributed to this (Calmfors 2012). They included a comprehensive tax reform in 1991, product-market deregulations in the first half of the 1990s, and reforms of the wage bargaining system in the late 1990s.

Figure 1. Fiscal consolidation, GDP growth and change in net exports in Sweden, 1993-2000



Source: AMECO and own calculations.

There were two fiscal effects of the higher long-term growth. First, it implied a reduction of the government debt-to-GDP ratio at a given primary fiscal balance (by about 10 percentage points). Second, the higher growth created a larger room for tax cuts and expenditure increases without deteriorations in the fiscal balance.

Conclusions

Sweden shows that a deep fiscal crisis can forge a political consensus on the need for budget discipline and trigger comprehensive reforms of the fiscal framework. This may provide cause for some optimism regarding the Eurozone. But the Swedish experiences also suggest that transparency and a high-quality policy debate may be more important for fiscal discipline than the German-type binding rules and automatic correction mechanisms that the Eurozone seems now to be heading for. Most importantly, Sweden illustrates the importance of swift real exchange rate depreciation for fiscal consolidation. Without it, fiscal retrenchment is bound to hurt growth and the consolidation process to be long and painful. In this sense, the Swedish experiences do not offer any consolation for the crisis countries in the EUrozone, which with the common currency have no instrument for afast real exchange rate depreciation.

Editor's note: This column is based on EEAG (2012), The EEAG Report on the European Economy, "The Swedish Model", CESifo, Munich 2012, pp. 99-114. The EEAG members are Jan-Egbert Sturm (KOF Swiss Economic Institute, ETH Zurich; Chairman), Lars Calmfors (Stockholm University), Giancarlo Corsetti (Cambridge University), John Hassler (Stockholm University), Gilles Saint-Paul (University of Toulouse), Hans-Werner Sinn (Ifo Institute and LMU University of Munich), Akos Valentinyi (Cardiff Business School) and Xavier Vives (IESE Business School). They are collectively responsible for each chapter in the Report. They participate on a personal basis and do not necessarily represent the views of the organisations they are affiliated with.

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