THE SWEDISH NATIONAL AUDIT OFFICE AUDITS PUBLIC FINANCES


# Transparency in the Budget Bill for 2014

## – Application of the fiscal policy framework

RIR 2013:23

SWEDISH NATIONAL AUDIT OFFICE

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THE SWEDISH NATIONAL AUDIT OFFICE

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SWEDISH NATIONAL
AUDIT OFFICE

TO THE RIKSDAG

DATE: 2013-12-06
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*We hereby deliver, in accordance with Section 9 of the Act on Audit of State Activities etc. (2002:1022) the following performance audit report:*

# Transparency in the Budget Bill for 2014 – Application of the fiscal policy framework

The Swedish National Audit Office has audited the transparency and clarity of the Government´s fiscal policy reporting in the Budget Bill for 2014. The audit focuses on three questions: are the macroeconomic assumptions reported so that their importance for following up the surplus target is clear, is the Government´s follow-up of the surplus target transparent, and are the Government´s considerations when striking a balance between the surplus target and stabilization policy clearly reported? The audit findings are presented in this performance audit report.

Representatives of the Ministry of Finance have been given the opportunity to check the accuracy of factual content and otherwise submit comments on the draft of the final report.

The report contains conclusions and recommendations addressed to the Government.

Auditor General *Claes Norgren* had the right of decision in this matter. Audit director *Krister Jensevik* was rapporteur. Audit directors *Thomas Hagberg* and *Lena Unemo* and Senior Auditor *Peter Johansson* assisted in the final processing.

Claes Norgren Krister Jensevik

*For information:*

The Government, the Ministry of Finance

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*continued*

# Summary

The Swedish National Audit Office has audited the transparency and clarity of the Government's fiscal policy reporting in the Budget Bill for 2014. The audit focuses on three questions: are the macroeconomic assumptions reported so that their importance for following up the surplus target is clear, is the Government's follow-up of the surplus target transparent, and are the Government's considerations when striking a balance between the surplus target and stabilization policy clearly reported?

## Audit background

*Motive:* The weak economic trend of recent years in the rest of the world has also impacted the Swedish economy. Public finances have deteriorated in the deep and prolonged recession downturn that has gone on for five years. In an international perspective Sweden has managed well up till now in the economic crisis, which is thought to be in part due to its having had a fiscal policy framework since the mid-1990s. The framework was introduced as a consequence of the crisis in public finances that Sweden suffered in the early 1990s and it aims to ensure stable and long-term sustainable fiscal policy. Credibility for the targets included in the framework demands transparent, clear and consistent reporting of the fundamentals of fiscal policy.

Since 2008 the Swedish National Audit Office has regularly audited the budget bills, mainly with respect to how the Government has applied the fiscal policy framework and transparency in reporting of fiscal policy. The audit now completed constitutes a part of this continuing work.

*Aim:* The overall aim of the audit has been to examine transparency and clarity of the Government's reporting in the Budget Bill for 2014. The audit poses the following audit questions:

- Are macroeconomic assumptions reported so that their importance for monitoring compliance with the surplus target is clear?
- Is the Government's follow-up of the surplus target transparent?
- Is the Government's reporting of its considerations when striking a balance between the surplus target and stabilization policy clear?

*Implementation:* The audit is mainly based on document studies and takes as its point of departure the Budget Act (2011:203) and its provisions concerning budgetary policy targets and the Government Communication 2010/11:79 *Ramverk för finanspolitiken* (Fiscal policy framework). The Communication aims at summarising the fiscal policy framework and the practice gradually developed since it was introduced. Supplementary points of departure for the audit are internationally accepted accounting principles for public finances.

## Audit findings

### *Monitoring the surplus target largely rests on the Government's assumptions concerning effects of the policy*

The surplus target means that general government net lending is to be an average of 1 per cent of GDP over a business cycle. Public revenue, which mainly consists of taxes, is highly dependent on economic growth. Many expenditures in the national budget are also closely connected to macroeconomic developments. A central part of monitoring the surplus target consists of forward-looking analysis. Consequently the principles for macroeconomic forecasting in the Budget Bill are of significance to monitoring the surplus target.

Forecasts for the current and the up-coming year in the Budget Bills are based purely on forecasting the business cycle. They aim to describe the most probable developments of GDP, employment, wages and prices etc. A more standardised estimate is made for the remaining three years in the medium-term perspective of the budget. It is normally assumed that the economy will return to its potential level at the end of the calculation period. The Government's assessment of potential output in the economy thus plays a major part in the budget's macroeconomic forecasting.

In the Budget Bill for 2014 the Government assesses that the policy pursued will have a noticeably greater effect on the potential level of output in the economy than other forecasters predict. The difference between the prevailing economic climate and the potential level is called the GDP gap. The Government's assessment means that the GDP gap in the Budget Bill is greater than the GDP gap estimated by other analysts with whom the Government compares itself. The consequence of a high estimated potential level, together with the assumption that the economy should approach the potential level within the calculation period, is that the growth rate is high in the last years of the calculations. This in turn means that net lending in the calculation is strengthened towards the end of the period to more than 1 per cent of GDP in 2017. The fact that net lending is in line with the target level towards the end of the calculation is thus largely a result of the assumed potential level of output.

When the macroeconomic forecast is reported in the Budget Bill it is clear how the Government's assumptions relate to the assessments of other forecasting institutions. It is also shown there that the assumption of a high potential level is based on assessments of policy effects on the functioning of the economy.

In monitoring the surplus target, however, the Government states that net lending will reach the target level at the end of the forecast period. However, the reporting does not show the effect of the assessment of potential GDP on the net lending forecast. Uncertainty in the assessment of the potential level is not discussed in that context. Transparency in the prospective follow-up of the surplus target would benefit from a clearer description of the significance of the macroeconomic assumptions.

### *The Government makes no overall statement on how the surplus target is met*

Under the Budget Act the Government is to report how the surplus target has been met and will be met. The Government presents formulations on target compliance in several sections of the Budget Bill. However, these formulations vary and do not clearly reflect whether the Government considers the surplus target to have been met or not. A reader is forced to make an overall assessment of several different statements in order to form an opinion. Transparency in the Budget Bill and application of the fiscal policy framework would benefit from an overall statement from the Government that answers the question of how the surplus target is met.

### *Unclear description of the balance between stabilisation policy and surplus target*

The surplus target has been formulated to be achieved over a business cycle, in order not to force the government to pursue a procyclical fiscal policy. The fiscal policy framework thus describes how the balance between stabilisation policy and achievement of the surplus target should be dealt with in various situations. However, the audit shows that in the Budget Bill for 2014 the Government does not describe sufficiently clearly how the proposed fiscal policy complies with the intentions of the framework in this respect.

An important premise for the arguments in the fiscal policy framework is a clear description of the starting position when considering this balance. The Government, however, takes no clear position on whether public finances deviate from the surplus target or not. For reporting to be transparent, all budget estimate assumptions that have great significance for whether fiscal policy is expansionary or contractionary should be clearly described. The budget shows clearly what share of the margin the proposed reforms will claim. But for the coming years the budget estimate also assumes, as is customary, that unchanged policy is pursued after implementation of the proposals presented in the budget. This means that in practice the estimate implies a contractionary fiscal policy in the later part of the calculation period.

In monitoring the surplus target the Government states that net lending will reach the target level only towards the end of the calculation period. However, it is not clear that the assumptions made concerning future tightening of fiscal policy constitute a significant premise for this development. Consequently it is also unclear if the scope for reform proposed in the Budget Bill for 2014 assumes future savings to achieve the surplus target. For an outsider it is difficult to relate the scope for reform to what will be required to achieve the surplus target in future. The consideration of fiscal policy proposed by the Government in the Budget Bill for 2014 thus also becomes difficult to interpret in relation to the undertakings made by the Government in the fiscal policy framework.

### *Budget elasticity needs to be evaluated*

In the audit the Swedish National Audit Office examined the importance of budget elasticity for the structural and cyclically adjusted indicators used when monitoring the surplus target.

Net lending is affected by the economy without the Riksdag deciding on changed revenue or expenditure. For example, net lending automatically decreases if the economy is weak and more people become unemployed, since tax revenue then decreases and public expenditure for unemployment increases. The Government calculates the effects of the economy on net lending with the help of the GDP gap and budget elasticity. The GDP gap specifies how much the use of resources in the economy deviates from an intended situation with full use of resources. This measure is multiplied by budget elasticity to obtain the magnitude of cyclical effect on public finances. Budget elasticity can therefore be called a measure of how sensitive general government net lending is to cyclical changes. The purpose of the structural and cyclically adjusted indicators is to describe the net lending that would be achieved at full resource utilisation in the economy.

The estimated budget elasticity used by the Government in its calculations is based on a calculation made by the OECD using data from 2003. When the measure was calculated, only parts of cyclically dependent labour market policy expenditure were taken into account. In addition the Riksdag has subsequently decided on reforms that may have impacted the relation between economic trend and public finances. It is true that budget elasticity has been estimated by other analysts since the OECD calculation was first published, but there is no continual follow-up of the automatic effects of the economic trend on public finances. Consequently, the Government could increase the transparency of budget calculations by reporting on and giving reasons for assumptions made and methods used concerning budget elasticity.

## Recommendations to the Government

- The Government should provide a sensitivity analysis concerning the impact of the potential GDP estimate and the assumption of a closed GDP gap at the end of the calculation period on achievement of the surplus target. This is particularly important if the Government's assessment of potential GDP differs from that of other analysts.
- The Government should present an overall statement on how the surplus target has been achieved and will be achieved.
- Apart from presenting the scope for reform, the Government should also more clearly present other assumptions of major significance to whether fiscal policy is expansionary or contractionary for each single year of the calculation period. This presentation should clearly report the prerequisites for achievement of the surplus target.
- The Government should consider compiling and publishing a current assessment of budget elasticity, or instruct an external analyst to undertake this task.

# 1 Introduction

## 1.1 Background and reason for the audit

International economic development continues to be weak. While last year's acute crisis in the euro area has subsided growth in the euro area continues to be limited. Development in emerging economies such as China and India has slowed and a number of emerging economies have shown signs of economic unrest, with falling exchange rates and increased inflation. In the USA, short-term business cycle statistics have certainly started to show somewhat more positive figures, but all in all the situation for the world economy remains uncertain. Thus it is not surprising that the Swedish economy is also growing slowly and that the prospects of a stronger economy are increasingly receding into the future.

Public finances have deteriorated in recent years, which is hardly surprising in view of economic developments. In an international perspective public finances appear, however, to be somewhat exemplary. A contributory factor is that since the mid-1990s Sweden has had a fiscal policy framework that aims to ensure stable and long-term sustainable fiscal policy. The credibility of the framework in general, and of the surplus target in particular, has enabled the Government to allow public finances to weaken so as to contribute to counter act cyclical fluctuations. This credibility is important to safeguard, particularly during periods when the Government must, for cyclical reasons, allow net lending to deviate from the surplus target level of 1 per cent of GDP.

The Swedish National Audit Office has regularly audited the budget bills, mainly with respect to how the Government has applied the fiscal policy framework and transparency in reporting of fiscal policy. Other issues have also been highlighted, such as the Government's framework for employment policy. The audit now completed is part of the recurrent audit of the application of the fiscal policy framework.

## 1.2 Purpose and audit issues

The overall aim has been to examine transparency and clarity in the Government's reporting in the Budget Bill for 2014. The audit focused on the following audit issues:

- Are macroeconomic assumptions reported so that their importance for monitoring the compliance with the surplus target is clear?
- Is the Government's monitoring of the surplus target transparent?
- Is the Government's reporting of its considerations when striking a balance between the surplus target and stabilisation policy clear?

## 1.3 Basic premises and grounds for assessment

The audit of the Budget Bill for 2014 is based on the Budget Act (2011:203) and its provisions concerning budgetary policy targets. An important complement to this is the Government Communication 2010/11:79, Fiscal Policy Framework. The Communication aims at summarising the fiscal policy framework, including the practice gradually developed since it was introduced. In addition there is Council Directive (2011/85/EU) of 8 November 2011 on requirements for budgetary frameworks of the Member States that is to be incorporated into national legislation by 31 December 2013. Any amendments to national legislation resulting from the Council Directive have been investigated by the Budget Process Committee (Fi 2012:10). Supplementary points of departure for the audit are internationally accepted accounting principles for public finances from the International Monetary Fund (IMF) and the OECD. The documents mentioned here on which grounds for assessment are based are summarised in Annex 1.

### *1.3.1 What can be required of the Government's reporting in the Budget Bill?*

Transparency in reporting of fiscal policy is basic from the point of view of democracy but is also decisive for confidence in fiscal policy. At the same time it is important that there is a balance so that transparency efforts do not lead to unreasonably high requirements concerning details and documentation.

Based on the documents above, the Swedish National Audit Office considers that reporting in the Budget Bill on the focus of fiscal policy should be understandable and cover relevant information necessary to enable independent evaluation of the Government's overall assessment. This means for example that it must be possible, using the specified premises presented in the Budget Bill, to evaluate the plausibility of the Government's assessments.

## 1.4 Implementation and scope of the audit

The audit refers to the Budget Bill for 2014 and is based on document studies.

## 1.5 Outline of the report

Chapter 2 deals with the Government's reporting of its' macroeconomic forecast. The Government's follow-up of the surplus target is reviewed in Chapter 3. Chapter 4 analyses the Government's reporting of the striking of the balance between stabilisation policy and meeting the surplus target. Chapter 5 deals with issues concerning the Government's reporting of budget elasticity. The final chapter of the report presents the audit conclusions and recommendations.

# 2 The importance of the macroeconomic trend for the surplus target

The surplus target means that general government net lending is to be an average of 1 per cent of GDP over a business cycle. Public revenue, which mainly consists of tax revenue, is highly dependent on growth. Many expenditure items in the national budget are also closely connected to the macroeconomic trend. Expenditure on labour market policy is perhaps the clearest example of this. The surplus target is monitored from both an ex post and ex ante perspective. Consequently, it is relevant to analyse the grounds for the macroeconomic forecasts when auditing the ex-ante follow-up.

## 2.1 Description of the medium term calculation in budget bills

The medium-term perspective in the budget process assumes a forecast of the macroeconomic trend for more than four years ahead.[1] The macroeconomic assessment forms the basis for calculations reported in the Budget Bill regarding public sector income and expenditure.

The calculations for the current and following year are based on business cycle forecasts. They aim to describe the most probable developments of GDP, employment, wages and prices etc. For the remaining three years of the medium-term budget perspective a more mechanical calculation is made without an express ambition to identify the cyclical development. It is normally assumed that the economy will return to a neutral level at the end of the calculation period. In the medium-term macro perspective the emphasis is laid on assessing the potential supply side and output capacity of the economy rather than on demand in the economy.

The choice of method has to do with the fact that uncertainty in economic cycle forecasts tends to be very great in the medium term. Consequently most forecasting institutions decide to move to a more supply driven forecasting method one to one and a half years into the forecast perspective. Thus the Government is not alone in using this approach; both the National Institute of Economic Research and the National Financial Management Authority use similar methods.

[1] The Budget Act requires that the budget calculations cover the current year and the three next years. Since the 2010 Spring Fiscal Policy Bill the Government has decided to add one year to the calculation.

## 2.2 The Government's presentation in the Budget Bill for 2014

### 2.2.1 *Forecast of economic activity 2013–2014*

In the Budget Bill the Government describes how the financial crisis and subsequent debt crisis have had far-reaching consequences for the Swedish economy. After the deep recession of 2009 the economy recovered temporarily for two years, but this was followed by another downturn in the international economy. International development in the first six months of this year continued to be weak. However, during the summer the Government and other forecasters saw indications of a return of confidence in the economy in important export countries. Thus there is an inkling of a somewhat stronger international trend, but this year Swedish growth will be low. Demand in the rest of the world is expected to increase again next year but the growth rate will be restrained and the main contributor to increased growth is household consumption.

**Table 2.1** The Government's macroeconomic forecast in the Budget Bill for 2014

| Expenditure in gross domestic product, percentage change and fixed prices | | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Level 2012** | **Average 1998–2012** | **2013** | **2014** | **2015** | **2016** | **2017** |
| GDP, calendar-adjusted | 3 567 | 2,6 | 1,2 | 2,6 | 3,3 | 3,5 | 3,1 |
| Household consumption expenditure | 1 718 | 2,5 | 2,1 | 3,1 | 3,9 | 3,6 | 3,1 |
| General government consumption expenditure | 956 | 1,2 | 1,0 | 1,1 | 0,2 | 0,7 | 0,6 |
| Fixed gross investment | 669 | 3,9 | –2,4 | 4,3 | 6,9 | 6,7 | 4,3 |
| Changes in inventories[a)] | –1 | 0,0 | 0,4 | –0,1 | 0,0 | 0,0 | 0,0 |
| Net exports1 | 220 | 0,4 | 0,0 | 0,0 | 0,3 | 0,6 | 0,4 |
| Exports | 1 736 | 4,9 | –2,3 | 3,0 | 6,8 | 7,7 | 6,2 |
| Imports | 1 516 | 4,5 | –2,7 | 3,3 | 7,1 | 7,4 | 6,1 |
| GDP gap[b)] | | –1,2 | –3,5 | –3,0 | –2,1 | –1,0 | –0,2 |

[a)] Contribution to GDP growth, percentage points.

[b)] The GDP gap shows the difference between actual and potential GDP as a percentage of potential GDP.

*Source: Govt. Bill 2013/14:1. Budget Bill for 2014*

The Budget Bill for 2014 compares the forecast on which budget calculations are based with comparable forecasts from other forecasting institutions. The conclusion drawn regarding the forecast of economic activity for 2013–2014 is that the budget forecast is fairly similar to other forecasts in the same timeframe.

### 2.2.2 *Economic capacity and the GDP gap*

At the outset the Government estimates that the economy is far under its potential output level. Other forecasting institutions share the opinion that the Swedish economy has excess capacity. On the other hand, there are different opinions as to how far the economy is from full capacity. One way of measuring economic capacity is the "GDP gap", which is the difference between actual and potential GDP. The Government's assessment of the potential level is by far the highest. For the current year the GDP gap is expected to be -3.5 percentage points. The fact that various forecasting institutions make different assessments is clear in the Budget Bill for 2014. There the GDP gap is compared at an overall level with several forecasting institutions; see Table 2.2. Since the forecasts of economic activity were relatively similar at the time the differences in the GDP gap can largely be explained by different assessments of the potential output level.

**Table 2.2** GDP gap

| | 2012 | 2013 | 2014 |
|---|---|---|---|
| Government (Budget Bill 14) | –2,7 | –3,5 | –3,0 |
| National Institute of Economic Research (Aug 2013) | –1,9 | –2,4 | –1,9 |
| European Commission (May 2013) | –1,3 | –1,6 | –1,1 |
| Riksbank (Sep 2013) | –1,1 | –1,6 | –0,8 |
| IMF (Sep 2013) | –0,4 | –1,0 | –0,7 |
| OECD (May 2013) | –1,4 | –2,7 | –2,9 |
| Government (Spring Fiscal Policy Bill 13) | –2,2 | –3,5 | –3,3 |

*Source: Govt. Bill 2013/14:1 and Govt. Bill. 2012/13:100.*

In summer 2013 the IMF pointed out that there was a wide range of estimates of potential growth in the Swedish economy.[2] This was interpreted as an indication of great uncertainty and for that reason they wanted to contribute to the debate with alternative calculations. In its country report of September 2013 the IMF presented three methodologically different calculations of the Swedish GDP gap. Calculations for 2013 resulted in a GDP gap that varied between -0.5 and -1.6 per cent, depending on the calculation method. The mean average for the three methods was -1 per cent; that is considerably less negative than the Government's estimate.

The methods for assessing potential GDP differ between different forecasting institutions. This makes comparison of results at a more detailed level difficult. However, the methods used by the Government and the National Institute of Economic Research are similar, which makes comparison possible. The Government presents this comparison in the Budget Bill. The comparison shows that it is mainly different assessments of potential hours worked that explain the differences in the GDP gap. According to the Government, this difference is due in turn to different assessments of past and future effects of various labour market reforms on the functioning of the economy. The reforms thought to have the greatest effect are the introduction and expansions of the earned income tax credit, changes in unemployment insurance, sickness insurance and the tax credit scheme for household services[3]. The Government stresses that the assessments build on research results, but that knowledge of the extent of the effects, particularly the rate at which their impact is felt, is highly uncertain.

### 2.2.3 *The medium-term perspective of the medium term calculation 2015–2017*

Both the Government's and the National Institute of Economic Research[4] medium-term calculations assume that the GDP gap will more or less close in the final year. Since the Government makes the highest estimate of the GDP gap at the outset it also has the highest rate of growth in the medium-term perspective. If the estimated rate of growth for 2016–2017 is compared with the corresponding assessment by the National Institute of Economic Research the difference per year is about 0.5 percentage points, see Table 2.3. The difference is mainly explained by the Government calculating with a clearly higher rate of growth for household consumption and exports.

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2 IMF (2013). *Sweden. 2013 Article IV consultation*. September 2013. IMF Country Report No. 13/277.

3 The tax credit system for household services covers household services (RUT) and services for housing repairs, maintenance and improvement (ROT). A tax credit is allowed for half the labour cost up to a total of SEK 50 000 per person and year.

4 National Institute of Economic Research (2013b). *Konjunkturläget augusti 2013*.

**Table 2.3** National Institute of Economic Research forecast in August 2013

| Expenditure in gross domestic product, percentage change and fixed prices | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | National Institute of Economic Research Aug 2013[c] | | | | | Difference Budget Bill 2014 – NIER Aug 2013 | | | | |
| | **2013** | **2014** | **2015** | **2016** | **2017** | **2013** | **2014** | **2015** | **2016** | **2017** |
| GDP, calendar-adjusted | 1,1 | 2,6 | 3,3 | 2,9 | 2,6 | 0,1 | 0,0 | 0,0 | 0,6 | 0,5 |
| Household consumption expenditure | 2,4 | 3,3 | 2,9 | 2,6 | 2,4 | –0,3 | –0,2 | 1,0 | 1,0 | 0,7 |
| General government consumption expenditure | 1,1 | 0,8 | 1,2 | 1,3 | 1,5 | –0,1 | 0,3 | –1,0 | –0,6 | –0,9 |
| Fixed gross investment | –2,6 | 5,1 | 8,2 | 7,1 | 5,0 | 0,2 | –0,8 | –1,3 | –0,4 | –0,7 |
| Changes in inventories[a] | 0,4 | –0,1 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 |
| Net exports[a] | –0,2 | –0,1 | 0,0 | –0,1 | 0,0 | 0,2 | 0,1 | 0,3 | 0,7 | 0,4 |
| Exports | –2,0 | 3,9 | 5,9 | 6,3 | 5,6 | –0,3 | –0,9 | 0,9 | 1,4 | 0,6 |
| Imports | –1,8 | 4,6 | 6,6 | 7,3 | 6,1 | –0,9 | –1,3 | 0,5 | 0,1 | 0,0 |
| GDP gap[b] | –2,4 | –1,9 | –0,8 | –0,2 | 0,1 | –1,1 | –1,1 | –1,3 | –0,8 | –0,3 |

[a] Contribution to GDP growth, percentage points.

[b] The GDP gap shows the difference between actual and potential GDP as a percentage of potential GDP.

[c] National Institute of Economic Research components in the expenditure in gross domestic product are calendar adjusted, which Is not the case for the corresponding value in the Budget Bill for 2014.

*Source: National Institute of Economic Research (2013b), Govt. Bill. 2013/14:1 and own calculations.*

### 2.2.4 *Risks and alternative scenarios*

The Government states that the medium term calculation assumes an international economic upturn and furthermore that the situation continues to be uncertain, above all in the OECD countries, and that an economic upturn can by no means be guaranteed. Growth in household consumption is also an important assumption. The Government believes that both these assumptions are associated with risks and that developments can be better or worse. The Government's overall assessment is however that the risks of a worse development predominate.

To describe the consequences of the risks the Government perceives, two alternative scenarios are presented in the Budget Bill. The first scenario analyses what an international interest rate hike would involve. The scenario describes considerably worse economic development and what it would mean for the budget. The GDP gap never closes in this scenario. Instead in the final year 2017 the gap is still large; as much as -2 percentage points. The second scenario describes far better development than the main scenario, with stronger international demand and higher consumer confidence. Here the GDP gap closes as early as in 2016 and in the final year the gap is +0.8 percentage points.

## 2.3 Analysis of the Government's presentation

### 2.3.1 *A new feature of the presentation is comparisons with other forecasting institutions*

A new feature of the Budget Bill for 2014 is that the Government very carefully and clearly compares and explains the differences between its own and others' forecasts and assessments. This increases transparency in the budget document. Moreover the alternative scenarios presented in both Budget Bills and Spring Fiscal Policy Bills are important tools for analysing different uncertainties in future development.

### 2.3.2 *The GDP gap and one single calculation assumption have crucial consequences for the decision-support data*

The Government's assessment of potential output in the economy is clearly higher than estimates made by other forecasting institutions. The difference between the Government's GDP-gap and that of the National Institute of Economic Research can be traced to the effects of different labour market reforms. Thus the Government estimates that the current reforms improve the functioning of the economy to a greater extent than the National Institute of Economic Research believes. The description of methods used at the beginning of this chapter shows that the assessment of potential output in the economy plays a major role in the budget's medium term calculation. The calculation builds on the assumption that the economy will return to its potential level towards the end of the calculation period. Public finances are highly dependent on the macroeconomic trend and therefore the assumption concerning potential growth in the economy will be entirely crucial for the budget forecast in the medium term perspective.

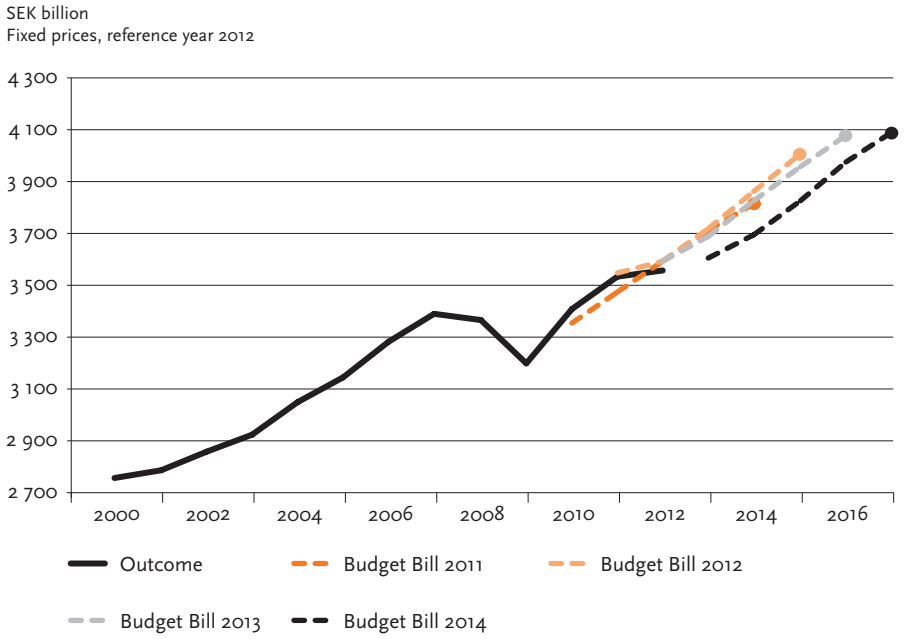
The surplus target is evaluated ex ante and with the help of cyclically adjusted indicators. The calculation of the cyclically adjusted indicators is carried out using the estimated GDP gap and the budget elasticity; see also Chapter 5.

In that way the assessment of the potential growth in the economy and the medium-term perspective play a decisive role in following up the surplus target. The follow-up of the surplus target is thus based to a great extent on one item of decision-support data.

### 2.3.3 *Three years of downward adjustments of the medium-term forecast*

Since 2008 the Swedish economy has grown at a considerably slower rate than its potential trend and output since 2009 has been far below its potential level. For the past three years the prospects of strong demand in the short-term perspective have been fairly limited. From a forecast perspective this means that two years into the forecast, that is next year, the GDP gap is still wide. To close the gap or approach the potential level during the forecast period the rate of growth must therefore increase considerably in the second half of the period. As time has passed and prospects of increased demand have not materialised the Government has been forced to extend the time for when the economy reaches its potential level; see Figure 2.1. The 2010 Spring Fiscal Policy Bill extended the forecast horizon from three to four years, which alleviated the calculation situation somewhat.

**Figure 2.1** The Government's calculations of GDP growth in the Budget Bill for 2011 to 2014




*Source: Statistics Sweden, Govt. Bill 2010/11:1, Govt. Bill 2011/12:1, Govt. Bill 2012/13:1 and Govt. Bill. 2013/14:1.*

The medium term perspective forms the basis of the ex-ante monitoring of the surplus target. Against this background there is reason to also analyse more extensively the prospects and plausibility of the forecast made for the period beyond the explicit business cycle activity forecast.

# 3 The Government's monitoring of the surplus target.

## 3.1 The Government's methods for monitoring the surplus target

The surplus target means that general government net lending is to be an average of 1 per cent of GDP over a business cycle. The formulation of the target as an average over a non-defined period of time makes it difficult to monitor. Over the years governments have developed a set of indicators to make it possible to evaluate target achievement. According to the Government the surplus target is to be seen as a "forward-looking benchmark", or "an anchor for fiscal policy", and therefore mainly be monitored from a forward-looking perspective, even if it is also important to make a historical analysis.

*A ten-year historical mean average* is used to determine whether there have been any systematic errors in fiscal policy that risk reducing probability of achieving the target in the future. When analysing the ten-year mean value the Government takes the average output gap into account for the period in question.

For the forward-looking evaluation the Government uses a set of indicators. Apart from the forecast of actual net lending *a seven-year central moving average* and structural net lending are used. The seven-year average is based on net lending for the year in question as well as three years forward and three years back in time. Here too the Government takes the economic situation for the period into account. *Structural net lending* is intended to show annually how net lending would have been in a situation with normal level of output in the economy.

The Government underlines that it is important to take the economic situation into account when monitoring the surplus target and when formulating future fiscal policy. As long as long-term sustainability is not questioned, fiscal policy should support stabilisation policy; in other words public finances should contribute to counteracting cyclical fluctuations.

## 3.2 The Government's monitoring of the surplus target in the Budget Bill for 2014

The Government starts its monitoring of the surplus target by analysing whether there are systematic errors in previously conducted fiscal policy. The ten-year average for 2003–2012 is 0.7 per cent of GDP, which falls somewhat short of the target level. However, since the output gaps in the period were negative on average the Government draws the conclusion that no systematic errors can be discovered.

**Table 3.1** Monitoring of the surplus target in the Budget Bill for 2014

| Per cent of GDP and potential GDP | | | | | | |
|---|---|---|---|---|---|---|
| | **2012** | **2013** | **2014** | **2015** | **2016** | **2017** |
| **Net lending** | **–0,6** | **–1,2** | **–1,5** | **–0,4** | **0,4** | **1,1** |
| Retrospective ten-year average | 0,7 | | | | | |
| Cyclically adjusted[a)] | 1,5 | | | | | |
| **Seven-year indicator** | **–0,8** | **–0,6** | **–0,4** | | | |
| Cyclically adjusted[a)] | 1,1 | 0,8 | 0,7 | | | |
| **Structural net lending** | **0,6** | **0,5** | **0,2** | **0,8** | **1,0** | **1,2** |
| **GDP gap** | **–2,7** | **–3,5** | **–3,0** | **–2,1** | **–1,0** | **–0,2** |
| Seven year average | –3,2 | –2,4 | –2,0 | | | |
| Retrospective ten-year average | –1,2 | | | | | |

[a)] Cyclical adjustment is through reducing the indicator value by the GDP gap for the corresponding period and multiplying by elasticity 0.55.

*Source: Govt. Bill 2013/14:1. Budget Bill for 2014*

A forward-looking analysis is then conducted, which shows that the seven-year indicator and structural net lending indicate that general government net lending is below the target level in 2012–2014. In the following years net lending is gradually strengthened and towards the end of the period net lending is in excess of 1 per cent of GDP. The gradual strengthening of net lending is partly because the medium term calculation assumes a sharp economic upturn in the medium term, which strengthens public finances, and partly because the calculation is based on unchanged policy after the proposed measures in the Budget Bill for 2014 have been implemented.

The calculations in the Budget Bill normally assume unchanged policy after the budget proposals have been introduced. This means practically that the estimates often include contractionary fiscal policy in the end of the calculation period. This effect arises when many expenditure items in the budget are not automatically indexed and thus tend to increase at a slower rate than tax revenue, which grows more in pace with GDP. According to The National Financial Management Authority the effects of an unchanged policy on net lending would be a strengthening on average by 0.4–0.5 per cent of GDP per year.[5]

## 3.3 Analysis of the Government's presentation

### *3.3.1 What does the Budget Act say?*

Under Chapter 9; Section 2 of the Budget Act (2011:203) the Government is to report how the surplus target is achieved. The legislative comments on the section mentioned specify that the report "must refer both to how the target has been achieved and how it is expected to be achieved"[6]. Thus according to the Budget Act the Government must state twice a year how the surplus target has been achieved and will be achieved.

### *3.3.2 The Government is unclear in its position*

As shown above the Government first makes a historical analysis of target achievement. Even if the Government maintains that the surplus target is mainly forward-looking, the historical analysis can meet the part of the legal requirement that refers to how the target has been achieved. The Government notes that net lending was in line with the surplus target in 2003–2012 taking the economic tendency into account. As regards the question of how the target will be achieved in future there are references to this in several parts of the Budget Bill, but there is no coordinated and clear statement of position. In section 5.3 of the Budget Bill, "Forward-looking analysis of target achievement", the Government notes only that net lending is below the target level in 2012–2015, but that net lending later strengthens gradually and exceeds 1 per cent of GDP towards the end of the period. The references do not answer the question of whether the surplus target has been achieved or not. In a fact box in the Budget Statement the Government writes that "a distinction must be made between achieving the surplus target and achieving the target level for net lending of 1 per cent of GDP". However, the same fact box contains the statement that the "fiscal policy conducted in which net lending achieves the target level only towards the end of the forecast period, *is thus compatible with the surplus target and fiscal policy framework*" (Swedish

[5] The National Financial Management Authority's calculation is presented in the Swedish Fiscal Policy Council (2011), p. 78–79.

[6] Govt. Bill 2009/10:100 section 4.3.1, p. 94.

National Audit Office's italics)[7]. However, there is no clear and coordinated assessment by the Government of how the surplus target is achieved; the references in the Budget Statement and in Chapter 5 differ in their formulation and possibly in their content.

### 3.3.3 *The GDP gap plays a decisive role for the monitoring outcome*

As shown in Chapter 2, the strong growth in the last years of the Budget Bill forecasts are a consequence partly of the calculation assumption that the economy will return to a neutral cyclical situation at the end of the calculation period; in other words that the GDP gap will close, and partly that the Government's assessment of the effects of labour market reforms on potential output in the economy will give a large GDP gap at the outset. These assumptions are, however, highly uncertain and this means that there is a major downward risk in the forecast, both for net lending and for structural net lending. The Government also points out that the downward risks predominate in the forecast.

It follows from this that if the effects of labour market reforms on the potential level of output in the economy are to be less than has been assessed or if the effects arise later in time, the surplus target will not be achieved in the forward-looking perspective. To put it another way: An assessment in the Budget Bill that fiscal policy is in line with the surplus target depends on the dynamic effects the Government's labour market reforms are expected to give rise to. When also taking into consideration the fact that the forecast is based on unchanged policy in the next four years, the achievement of the target appears to be highly uncertain.

[7] Govt. Bill 2013/14:1 Proposed central government budget etc. p 16.

# 4 The surplus target and stabilisation policy

## 4.1 The Government's view of how deviations from the surplus target should be dealt with

The surplus target has been formulated to be achieved over a business cycle, in order not to force the Government to pursue a procyclical fiscal policy. The fiscal policy framework describes how the balance between stabilisation policy and achievement of the surplus target should be dealt with in various situations.[8] The principles for how various decision-making situations are to be dealt with are based on the size of the deviation from the surplus target and the prevalent economic tendency. The framework presents a stylised picture of how fiscal policy should be focused in various situations, see Figure 4.1.

**Figure 4.1** Correcting surplus target deviations with allowance for the business cycle

| | | Assessed surplus target compliance | | |
|---|---|---|---|---|
| | | Above the target | On target | Below the target |
| Resource utilisation | High | Balance-weakening measures when the economy slackens | No measures | Balance reinforcement at a high rate |
| | Normal | Balance weakening measures at a moderate rate | No measures | Balance reinforcement at a moderate rate |
| | Low | Balance weakening measures at a high rate | No measures | Balance reinforcement as the economy recovers |

*Source: Government Communication 2010/11:79 The Swedish fiscal policy framework.*

8 Government Communication 2010/11:79 The Swedish fiscal policy framework.

According to the Government, the figures above should be seen just as a stylistic description of different decision-making situations. In practice the situation may be such that circumstances other than those described above must also be taken into account when dealing with deviations from the target. The Government also writes as follows: "It is important, however, that stabilisation policy is based on clear principles so that deviations from the target for other reasons are not motivated with reference to stabilisation policy."[9]

## 4.2 The Government's view of stabilisation policy

The fiscal policy framework also describes the Government's view of stabilisation policy.[10]

In the case of *normal demand shocks* monetary policy helps to stabilise both inflation and demand in the economy. On these occasions normally no active fiscal measures are needed for stabilisation. On the other hand, the economy is stabilised by the automatic and semiautomatic stabilisers that are inherent in the public finances.

When there are *major demand shocks and supply shocks* the Government is of the opinion that fiscal policy can play a role in supporting monetary policy. However, previous crises show that fiscal policy cannot fully counter act a sharp economic downturn without endangering public finances. However, fiscal policy can help to mitigate the negative effects of severe recessions. The Government writes as follows: "The measures of stabilisation policy are to be constructed so that they do not obstruct actual net lending's return to a level in line with the surplus target when resource utilisation normalises."[11]

*Temporary measures* can be considered to counter an economic downturn, but in that case it is important to take steps to ensure that they are in fact temporary.

*Permanent measures* can be used to mitigate effects of a downturn given that there is budgetary room for them. The view of the Government is that in these cases measures should in the first place be chosen that tend to make the economy more efficient.

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9 Ibid. p. 25.

10 Ibid.

11 Government Communication 2010/11:79, *Ramverk för finanspolitiken* (The Swedish fiscal policy framework), p 7.

## 4.3 Analysis of the Government's presentation in the budget bill for 2014

### 4.3.1 *The Government is not giving a clear message about the decision-making situation*

The analysis in section 3.3.2 shows that it is difficult to interpret the Government's position on whether the surplus target has been met or not. Therefore, it is also difficult to interpret the decision-making situation the Government believes it is faced with in comparison to the matrix in Figure 4.1.

One interpretation that can be made is that the Government believes that circumstances correspond to the lower central box in the matrix. That is, that capacity utilisation is low and net lending is on target. The interpretation is made on the assumption that fiscal policy conducted is more or less neutral. The active measures proposed in the budget are of the same dimensions as the automatic restraints that are inbuilt in the budget rules. As we explained earlier, this restraining effect arises because many items of expenditure are not automatically indexed. Expenditure therefore tends to increase at a slower pace than income.

Another interpretation is that the Government considers it is facing the lower right box of the matrix. That is to say that resource utilisation is low while net lending is below target. This interpretation assumes the Government means that net lending will be below target up to and including 2015 and only thereafter will be strengthened, as long as no new reforms are carried out.[12] Since the budget rules automatically entail contractionary fiscal policy as of 2015, a contractionary policy would thus be required later for target compliance in 2017.

A consequence of this lack of clarity is that the Government's position will be unclear as regards the starting position for weighing surplus target compliance against stabilisation policy.

### 4.3.2 *The choice between stabilisation policy and surplus target compliance is unclear*

A precondition for net lending in the Government's calculation being in line with target is that a contractionary policy is pursued further ahead. The restraints now included in the calculation mainly consist of central government expenditure that is not automatically indexed. If the real value is to be maintained in public sector activities this expenditure must be indexed. New priorities will then be required if net lending is to revert to being on target. This means that in 2014 the Government will use so much of the scope for reform to support economic recovery that future savings will be necessary to meet the surplus target. This information emerges indirectly when analysing

[12] Govt. Bill 2013/14:1 Proposed central government budget etc. p 184.

the Government's calculations[13] and statements in the Budget Bill. The Government chooses to express it thus: "the assessment is based on unchanged fiscal policy"[14] and that "great restraint in fiscal policy will be needed ahead"[15].

If the Government were to present this type of important information in a more transparent way it would improve understanding of the assumptions on which the calculations are based. This would also increase the possibilities of evaluating fiscal policy conducted.

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[13] For calculation see Govt. Bill. 2013/14:1 Proposed central government budget etc., Table 5.1 p. 181 and explanation of table, p. 182.

[14] Govt. Bill 2013/14:1 Proposed central government budget etc. p 184.

[15] Ibid. p. 196.

# 5 Effects of the economy on public finances

## 5.1 Structural net lending

Calculations of structural net lending are based on public finances consisting of structural and cyclical components, where cyclical net lending can be identified through automatic stabilisers. The automatic stabilisers are contracyclical and specify how net lending is affected during cyclical fluctuations without the Riksdag having decided to change public sector revenue or expenditure. For example, net lending automatically decreases if the economy is weak and more people become unemployed, since tax revenue then decreases and public expenditure for unemployment increases.

The size of the automatic stabilisers is calculated using the GDP gap and budget elasticity. The GDP gap specifies how much capacity in the economy deviates from a situation of full capacity, and this value is multiplied by budget elasticity to obtain the size of the automatic stabilisers. It can be said that budget elasticity is a measure of how sensitive general government net lending is to cyclical changes. The measurement specifies how much general government net lending is affected if capacity changes and is dependent on such factors as unemployment benefit payments and the size and design of taxes.[16]

The measurement of budget elasticity used by the Government was calculated in a report published by the OECD in 2005. The report studies cyclical net lending in several OECD countries and budget elasticity for Sweden was calculated to be 0.55.[17] This means that automatic net lending changes by 0.55 per cent of GDP if the GDP gap changes by one percentage point.

There are risks associated with overstating or understating the force of the automatic stabilisers through misjudging budget elasticity. If budget elasticity is overstated in the analysis the contra-cyclical force in fiscal policy will also be overstated. In a recession a misjudgement of the automatic stabilisers' effect can result in an overestimation of structural net lending. If budget elasticity is

[16] The account above is based on data in Boije, Robert (2004), p. 5–11; Swedish Fiscal Policy Council (2009), p. 51–56; (2011), p. 45–63.

[17] Girouard, Nathalie & Christophe André (2005), p. 22.

misleading forecasts of future net lending may prove to be far too optimistic or pessimistic even if the GDP gap develops as forecast.

Table 5.1 presents a sensitivity analysis for how cyclically adjusted net lending is affected by various budget elasticity assumptions. The calculation is based on the Government forecast for 2013 in the Budget Bill, in which net lending amounts to –1.2 per cent of GDP and the GDP gap is assumed to be –3.5 per cent. Budget elasticity in the calculation varies by 0.1 percentage points around the Government's current estimate.

**Table 5.1** Significance of budget elasticity for calculation of cyclically adjusted net lending

| Cyclically adjusted net lending (S) | Net lending (F) | Budget elasticity (ε) | GDP gap (▲) |
|---|---|---|---|
| 0,4 | –1,2 | 0,45 | –3,5 |
| 0,7 | –1,2 | 0,55 | –3,5 |
| 1,1 | –1,2 | 0,65 | –3,5 |

$S = F - \varepsilon \cdot \blacktriangle$

S, F and ▲ as percentage of GDP.

*Source: Govt. Bill 2013/14:1. Budget Bill for 2014 and own calculations.*

Table 5.1 shows that when there is a large GDP gap, relatively small changes in budget elasticity are of great significance for the result obtained when cyclically adjusted net lending is calculated.

## 5.2 Difficult to reflect cyclical effects

Calculating the strength of the automatic stabilisers using the GDP gap and budget elasticity is usually called the aggregated method. Whether the method is the most appropriate for calculating structural net lending is a matter that has been discussed. A central point of that discussion is that the OECD's and the Government's method of calculating the automatic stabilisers does not identify the so called composition effects of cyclical changes. Depending on the driving forces in the economy, the development of each separate tax base and expenditure base will not necessarily follow GDP growth.

One example that is often cited is that a recession caused by a decrease in demand for exports does not need to have the same impact on the automatic stabilisers as it would if it had been caused by a domestic decrease in demand. Another example is that the aggregated method does not either identify changed consumption patterns in cyclical fluctuations. Given that goods and

services are taxed at different tax rates, changed patterns of consumption can impact tax revenues in a way that is not identified by the aggregated method.[18]

Yet another conceivable composition effect is the distribution of unemployment over income levels. When calculating budget elasticity tax levels and average marginal tax are taken into account. The marginal tax rate varies at different income levels and the average is calculated using income distribution.[19]

This method does not, however, identify the effects of unemployment being distributed differently between income levels. If marginal taxes are lowest for people with lowest incomes and if this group is also at the greatest risk of unemployment, budget elasticity will actually be less than indicated by the calculations.

Disaggregated methods can be used to offset that type of problem. A disaggregated method calculates the strength of the automatic stabilisers using trend analysis of the respective tax bases and expenditure bases (such as unemployment).[20] It is often maintained that this type of method identifies cyclical composition effects better. In a follow-up of the surplus target by a working group in the Ministry of Finance in 2010 it was proposed that the Government should consider using a disaggregated method as a complement to the aggregated method.[21]

## 5.3 The Government's presentation

In previous bills the Government has pointed out that there are different methods for calculating structural net lending, and that these methods have their different weaknesses and strengths. In its 2011 Spring Fiscal Policy Bill the Government shows how the results of different methods of calculating structural net lending can differ. The Government states that the aggregated method does not identify composition effects but that these differences can be identified using disaggregated methods, in which each individual tax base is measured separately. At the same time the Government points out that the aggregated method is simple to use and that it is used by organisations such as the OECD and the IMF.[22]

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18 Boije, Robert (2004), p. 1718; Ministry of Finance (2010), p. 198; Swedish Fiscal Policy Council (2012), p. 70–73.

19 See for example Flodén, Martin (2009) on Swedish income tax.

20 For a description of disaggregated methods see Boije, Robert (2004), p. 15–23; Ministry of Finance (2010), p. 209–211.

21 Ministry of Finance (2010), p. 210. See also Swedish Fiscal Policy Council (2012), p. 73–75.

22 Govt. Bill 2010/11:100, section 10, p. 197, see also 2011/12:1, p. 189.

## 5.4 Calculating budget elasticity

Given that the Government continues to calculate structural net lending using an aggregated method there may be reason for it to present the budget elasticity calculations. There are issues associated with the calculations of budget elasticity on which the Government has not reported its standpoint or clearly motivated its assumptions. Two questions are dealt with below. One concerns how the measure should be re-examined taking into account previous Riksdag decisions and the other concerns which expenditures and revenues that should be included in calculations of budget elasticity.

### 5.4.1 *Change over time?*

The OECD has calculated Swedish budget elasticity using data from 2003. Since then the earned income tax credits have been introduced and the tax ratio in Sweden has fallen since 2005.[23] There is a relatively strong correlation between budget elasticity and the size of a country's public sector.[24] In addition the benefit levels of unemployment insurance have been reduced, while relatively fewer people are covered by the insurance. If the taxes decrease and expenditure on unemployment falls, budget elasticity can also decrease.

In the 2011 Spring Fiscal Policy Bill the Government states that budget elasticity is 0.55 and "is in line with the latest OECD calculations"[25]. The Government has not reported any additional follow-up of budget elasticity. The calculations that other analysts have made give no clear-cut picture of how the measurement has developed.

In light of the Riksdag decisions on earned income tax and changes in unemployment insurance, in 2009 the Swedish Fiscal Policy Council initiated a survey on whether budget elasticity had changed over the years. The calculations apply to the period 1998–2009 and were based on the same methods used in the OECD study concerned. The survey did not show that budget elasticity had been affected to a great extent during the period. The result was that it continued to be close to the OECD measurement. The fact that earned income tax credits have not affected budget elasticity to a greater extent is explained by the simultaneous rise in marginal tax. The decrease in budget elasticity following from reduced income tax has been offset by increased marginal tax.[26]

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[23] Swedish Tax Agency (2012), p. 99. In the Budget Bill for 2014 the Government assesses that the tax ratio is between 44 and 45 per cent in the years 2012–2017, see Govt. Bill 2013/14:1 Proposed central government budget etc. p 540.

[24] Girouard, Nathalie & Christophe André (2005), p. 25; Swedish Fiscal Policy Council (2009), p. 54.

[25] Govt. Bill 2010/11:100, section 10, p. 196.

[26] Flodén, Martin (2009), p. 56, 10–12.

The National Institute of Economic Research calculates the cyclical effect on public finances using another method[27] and finds that budget elasticity has fallen over time and is now lower than the Government's and the OECD's estimates. The National Institute of Economic Research calculates that budget elasticity is 0.4 in the period 2007–2012 and 0.8 in the period 1995–2006. The National Institute of Economic Research refers to the fact that a falling tax ratio and reduced effective gross compensation rates in the social security systems have contributed to a fall in budget elasticity.[28]

### 5.4.2 *What should be included?*

Another aspect of budget elasticity calculations is the question of which expenditures to be taken into account.

One example is public expenditure on active labour market policy. In previous calculations the OECD has included public sector expenditure on active labour market policy, as well as subsidised employment and early retirement. However, this expenditure is not included in the calculations of the measurements published by the OECD in 2005 that were used by the Government. The reasons included the fact that in some cases there were no national data for subsidised employment and early retirement (disability pension). The authors of the report emphasise that this may mean that budget elasticity is underestimated for some countries.[29]

The report to the Swedish Fiscal Policy Council mentioned above illustrates that it is significant whether this expenditure is included in the calculations or not. Here an alternative calculation of budget elasticity is presented in which expenditure on active labour market policy is included. When this expenditure is included budget elasticity increases and the change in the measurement during the period studied increases.[30]

The Government does not explain the distinction between expenditure that should or should not be included in the calculation of budget elasticity. It can be noted that the Government does not regard public sector expenditure on active labour market policy as entirely independent of cyclical fluctuations in the economy. In the Budget Bill the Government speaks of both automatic and semi-automatic stabilisers. The expenditure increases that "as a rule are decided when unemployment increases for cyclical reasons" are counted as semi-automatic stabilisers. The Government adds that future expenditure

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[27] See Ministry of Finance (2010), p. 209 and the reference cited there.

[28] National Institute of Economic Research (2013a), p 48-49.

[29] Girouard, Nathalie & Christophe André (2005), p. 20, in particular footnote 27.

[30] Flodén, Martin (2009), p.17.

following from the new proposal for short-time employment can also be counted as semi-automatic stabilisers.[31]

### 5.4.3 *Local government expenditure*

Another example of the question of what should be included in budget elasticity calculations is local government expenditure. The Swedish Fiscal Policy Council has discussed how local government balanced budget requirements can affect budget elasticity calculations. The Council points out that local governments (municipalities and county councils), due to the balanced budget requirement in the fiscal policy framework, may be forced to act procyclically in a downturn. The idea is based on local government finances being essentially dependent on income tax revenues. In a downturn, when revenues decrease, local government may be forced to act procyclically to achieve the balanced budget requirement, either through reducing volumes in their activities or by raising taxes. For that reason the Swedish Fiscal Policy Council believes that it can be questioned whether expenditure financed by local governments themselves should be included as part of budget elasticity. This applies rather to extended and deep recessions rather than short minor downturns.[32]

In other contexts the Government has stated that there is a risk of local government acting procyclically during a recession. In the 2009 recession the Riksdag passed a Government Bill on temporary countercyclical support to local government. In connection with this the Government announced that it would review the local government balanced budget requirement.[33] In 2010 the Government set up a government inquiry on how "procyclical variations in local government finances can be prevented".[34]

In June 2012 the Riksdag enacted a Government Bill to introduce local government profit equalisation reserves. These allow the municipalities and county councils to set aside some of the surplus that may arise in some years to be used later. The Act is formulated to enable local governments to retroactively reserve part of the surplus from 2010. The Government assesses that the proposal can strengthen the automatic stabilisers, since the reserves mean that local governments will not have the same need to reduce their expenditure in an economic downturn. It may also mean that the need for discretionary measures will decrease.[35]

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[31] Govt. Bill 2013/14:1 Proposed central government budget etc. p 181.

[32] Swedish Fiscal Policy Council (2011), p. 56–63.

[33] Committee report 2008/09: FiU21, p. 37–38.

[34] Government's terms of reference 2010:29, p. 1.

[35] Govt. Bill 2011/12:172, p. 16, 39.

As far as is possible to determine from the Budget Bill this has not resulted in the Government recalculating budget elasticity.

## 5.5 Summary of findings

This section has dealt with the Government's follow-up of structural net lending using budget elasticity and the GDP gap. We establish in the section that the Government's approach is associated with a number of methodological issues. Particular focus is directed at budget elasticity follow-up issues and assumptions concerning which expenditure should be included when the measurement is calculated.

In summary the Government does not present the measurement clearly in this year's Budget Bill. Nor has the Government commented on the measurement by raising and dealing with questions associated with its calculation, for example how it should be re-examined with regard to the policy decided by the Riksdag and the grounds on which some, but not other, expenditure should be included in the calculation.

# 6 Conclusions and recommendations

The Riksdag has decided that general government net lending is to be an average of 1 per cent of GDP over a business cycle. Since the surplus target is expressed as an average over an undefined period of time, this places great demands on clear and transparent reporting of target fulfilment. Under the Budget Act the Government is to report twice a year on how the surplus target is achieved. In this audit of the Budget Bill for 2014 the Swedish National Audit Office has dealt with four different aspects of the Government's monitoring of the surplus target:

- the significance of macroeconomic assumptions for calculating target fulfilment, in particular the assumption concerning the economy's potential level of output
- the Government's reporting and analysis of target fulfilment
- the Government's reporting concerning the striking a balance between surplus target fulfilment and conducting stabilisation policy
- the effect of business cycles on public finances; that is the calculation of budget elasticity.

## 6.1 Monitoring the surplus target largely rests on the Government's assumptions concerning policy effects

As shown in the audit, in the Budget Bill the Government makes an assumption that the effects of the policy conducted on the Swedish economy's potential level of output will be noticeably greater than is assumed by other forecasters. The effect of this is that the GDP gap in 2013 in the Government's calculations is greater than that assumed by the analysts with whom the Government compares itself. The macroeconomic calculations for the last years in the Budget Bill are based on the assumption that the GDP gap will close, in other words that capacity in the economy will approach equilibrium at the end of the calculation period. Together with a high estimate of potential GDP, the result of this assumption is that the growth rate in the economy will be high in the last years of the calculation period. This in turn will have the effect that net lending in the calculation is strengthened towards the end of the period to more than 1 per cent of GDP in 2017. The fact that net lending is in line with the target level towards the end of the calculation is thus largely a result of the assumed potential output level.

When the macroeconomic forecast is reported in the Budget Bill it is clear how the Government's assumptions relate to the assessments of other forecasting institutions. It is also shown there that the assumption of a high potential level is based on assessments of policy effects on the functioning of the economy.

When the Government assesses fiscal policy conducted against the surplus target, it refers to the assumption that net lending and structural net lending will achieve the target level at the end of the forecast period. However, the reporting does not show the effect of the assessment of potential GDP on the net lending forecast. Uncertainty in the assessment of the potential level is not discussed in that context. The assessment of the potential level of the economy is of great significance for the forward-looking follow-up of the surplus target, as the calculation is based on the assumption that this level will be achieved at the end of the calculation period.

### 6.1.1 *Recommendation*

The Government should provide a sensitivity analysis concerning the impact of the potential GDP estimate and the assumption of a closed GDP gap at the end of the calculation period on achievement of the surplus target. This is particularly important if the Government's assessment of potential GDP differs from that of other analysts.

## 6.2 The Government makes no overall statement on how the surplus target is met

Under the Budget Act the Government is to report how the surplus target has been met and will be met. The Government presents formulations on target compliance in several places in the Budget Bill. However, these formulations vary and do not clearly reflect whether the Government considers the surplus target to have been met or not. Transparency in the Budget Bill and application of the fiscal policy framework would benefit from an overall statement from the Government that answers the question of how the surplus target is met.

### 6.2.1 *Recommendation*

The Government should present an overall statement on how the surplus target has been achieved and will be achieved.

## 6.3 Unclear description of the balance between stabilisation policy and surplus target

The Swedish National Audit Office has analysed the Government's reporting of striking a balance between fulfilment of the surplus target and conducting stabilisation policy. The audit shows that the reporting does not describe sufficiently clearly how the Government's proposed fiscal policy follows the intentions of the fiscal policy framework.

An important precondition for being able to evaluate the policy is a clear description of the starting position when considering this balance. To clarify the starting position requires the Government to take a clear stance on whether public finances deviate from the target level.

Another important precondition is that the scope for reform and other important premises in the calculation are reported clearly. The budget scope proposed for new reforms should be stated clearly. But the budget estimate assumes that unchanged policy will be pursued after implementation of the proposals presented in the budget. This means that in practice the estimate implies a contractionary fiscal policy in the later part of the calculation period. In monitoring the surplus target the Government states that net lending will reach the target level only towards the end of the calculation period. However, it is not clear that the assumptions made concerning future tightening of fiscal policy constitute a condition for this development. Consequently it is also unclear if the scope for reform proposed in the Budget Bill for 2014 assumes future savings to achieve the surplus target. It is not possible for an outsider to relate the scope for reform to required efforts for achieving the surplus target. Consequently it is difficult to interpret the considerations in relation to the fiscal policy framework.

### *6.3.1 Recommendation*

Apart from presenting the scope for reform, the Government should also more clearly present other assumptions of major significance to whether fiscal policy is expansionary or contractionary for each single year of the calculation period. This presentation should clearly report the prerequisites for achievement of the surplus target.

## 6.4 Budget elasticity needs to be evaluated

In the audit the Swedish National Audit Office examined the importance of budget elasticity for the structural and cyclically adjusted indicators used when monitoring the surplus target. The estimated budget elasticity used by the Government in its calculations is based on a calculation made by the OECD using data from 2003. When the measure was calculated, only parts of cyclically dependent labour market policy expenditure were taken into account. In addition, the Riksdag has subsequently implemented reforms that may have impacted the relation between the economic trend and the development of public finances. It is true that budget elasticity has been estimated by other analysts since the OECD calculation was first published, but there is no recurrent follow-up of the automatic effects of the economic trend on public finances. Consequently, the Government could increase the transparency of budget calculations by reporting on and giving reasons for assumptions made and methods used concerning budget elasticity.

### *6.4.1 Recommendation*

The Government should consider compiling and publishing a current assessment of budget elasticity, or instruct an external analyst to undertake this task.

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# Annex 1 Basic premises and grounds for assessment

## Budget Act

The Government's authority and obligations in the area of financial power are regulated, apart from by the Instrument of Government and the Riksdag Act, by the Budget Act (2011:203). The Budget Act was reformed in 2011 for the purpose of strengthening the central government budget framework. The changes included clarifying the allocation of authority between the Riksdag and the Government in the area of financial power, increasing transparency and strengthening budget discipline.[36]

The Budget Act contains a number of specific provisions concerning the contents of the Budget Bill. For example, if the Riksdag has decided on a surplus target, the Government must report to the Riksdag at least twice during the year on how the target is being met (Chapter 9, Section 2). Furthermore the Government must present forecasts of central government income and expenditures, the central government borrowing requirement and expenditures under the expenditure ceiling. The forecasts shall cover the current budget year and the three immediately following years and shall be based on well-defined assumptions (Chapter 9, Section 3). Furthermore, the Government shall explain significant differences between budgeted amounts and estimated outcomes in the current budget year. (Chapter 9, Section 1, second paragraph). The preparatory works for the Budget Act also emphasise the importance of the forecasts in the documents being designed to enable comparisons to be made with the forecast made in the latest budget document.[37]

## Communication: the fiscal policy framework

In the Government Communication 2010/11:79, the Swedish fiscal policy framework, the Government describes the fiscal policy framework. The purpose of the communication is, according to the Government, to summarise the fiscal policy framework so as to strengthen confidence that the formulation of fiscal policy is long-term sustainable and transparent. The communication also aims to define precisely some parts of the

[36] Govt. Bill 2010/11:40 p. 135–136.

[37] Swedish Government Official Reports SOU 2010:18ps. 283 and Govt. Bill 2010/11:40 p. 129.

framework and its application by the Government. According to the Government, broad political support for the fiscal policy framework can reduce uncertainty about future formulation of the fiscal policy components that the framework covers, thus creating more stable macroeconomic development. According to the communication, the fiscal policy framework is also aimed at "increasing the credibility of Sweden fulfilling the requirements of the EU Stability and Growth Pact and of the *then* [Swedish National Audit Office's note] coming EU Budgetary Framework Directive".

In the Communication the Government emphasises that fiscal policy covers several different means and objectives and that formulation of fiscal policy is also dependent on political considerations. However, according to the Government there are a number of fundamental principles that fiscal policy should follow to be long-term sustainable and transparent. These principles constitute the fiscal policy framework and according to the communication consist of the following components:

- a budget policy framework consisting of a surplus target for the public sector, an expenditure ceiling for central government and the old age pension system expenditure and a local government balanced budget requirement with a tight central government budget process
- Principles for how fiscal policy should be formulated from the perspective of stabilisation policy
- Principles for how central government intervention in the financial markets should take place to safeguard public finances
- principles for clear and transparent reporting of fiscal policy.

According to the communication, the budgetary policy framework is a central part of the fiscal policy framework and must be used to create better conditions for achieving the overall fiscal policy targets without jeopardising public finances. In the communication the Government describes the regulation of budgetary policy targets in legislation and their motives, as well as how the Government applies the targets and deals with deviations.

In the communication the Government states that it is important that reporting of fiscal policy is transparent and comprehensive. This is to make it possible to follow up fiscal policy and ensure that the fiscal policy framework steers policy. The Government establishes in the communication that it must be possible for the public to have insight into all aspects of fiscal policy.

## Council Directive on Requirements for Budgetary Frameworks of the Member States and the conclusions of the Budget Process Committee

The Council Directive on Requirements for Budgetary Frameworks was adopted on 8 November 2011. According to the Directive Member States must have introduced the

laws and other statutes necessary to comply with the Directive by 31 December 2013. The Directive also emphasises the importance of openness and insight to be able to quality assure data in public finances. As one of the reasons for adopting the Directive it is stated that "openness and transparency are decisive for ensuring that the forecasts used for budgetary policy are realistic, which should mean public access not only to the official macroeconomic forecasts and budget forecasts drawn up for fiscal policy planning, but also the methods, assumptions and relevant parameters on which these forecasts are based".

In the interim report *Budgetramverket – uppfyller det EU:s direktiv?* (Does the budget framework comply with EU directives?) (Swedish Government Official Reports SOU 2013:32) from the Budget Process Committee (Fi 2012:10) the Committee's overall assessment is that the Swedish budgetary framework, through legislation or case law, complies with the requirements of the EU Directive in all areas, with the exception of the requirement to present regular, objective and complete evaluations of the Government's macroeconomic forecasts and budget forecasts. Consequently the Committee proposes a supplement to the Budget Act concerning these points.

In the final report of the Budget Process Committee "En utvecklad budgetprocess – ökad tydlighet och struktur" (A developed budget process - increased clarity and structure) (Swedish Government Official Reports SOU 2013:73) further amendments are proposed to national legislation aimed at increasing transparency of reporting. As regards follow-up of the surplus target, the Committee proposes the introduction of a provision in the Budget Act directing that in the event of an expected deviation from the target the Government must also describe what will be done to get back on track. The Committee also proposes that a provision be added to the Budget Act to the effect that the Government, when reporting to the Riksdag on how the target is being met, takes into account the effects of decided and proposed budget policy measures. The Government Offices are now preparing the proposals.

## International accounting principles

The IMF's "Fiscal Transparency Code"[38] and the OECD's "Best Practices for Budget Transparency"[39] are examples of internationally accepted accounting principles for transparency in the fiscal policy area. The IMF's "Fiscal Transparency Code" is divided into four areas: clear roles and responsibilities, transparent budget processes, public availability of information and assurances of integrity. Criteria are given in these four areas that must be met to comply with the transparency requirement. A transparent budget process includes, according to the IMF principles, fiscal policy targets and rules

[38] IMF (2007), Manual on Fiscal Transparency.

[39] OECD (2002).OECD Best Practices for Budget Transparency, OECD Journal on Budgeting, Volume 1, No. 3, 2002.

being clearly expressed, simple and well-defined. The IMF principles also state that fiscal policy transparency requires public access to information. The IMF considers that citizens must have access to full information on the Government's targets and financial activities and this should be reported in a way that facilitates evaluation and accountability. Moreover, financial data should meet quality requirements and be consistent.

The OECD's "Best Practices for Budget Transparency" contains similar principles to the IMF's "Fiscal Transparency Code". The OECD defines budget transparency as "full disclosure of all relevant fiscal information in a timely and systematic manner" (OECD 2002). According to the OECD principles the budget should include full information on expenditure and revenue and explicit reporting on the main economic assumptions on which the budget is based.

**IMF definition of fiscal policy transparency**

The IMF defines fiscal policy transparency as public openness about the structure and functions of government, fiscal policy intentions, public sector accounts and fiscal projections. This assumes good access to reliable, comprehensive, current, understandable and internationally comparable information on public sector activities, so that electors and the financial markets can correctly assess the financial position and actual costs and benefits of central government activities, including their current and future economic and social consequences (Kopits 1998).[40]

**OECD definition of budget transparency**

The OECD defines budget transparency as full disclosure of all relevant fiscal information in a timely and systematic manner (OECD 2002).[41]

[40] Kopits, George, and Jon Craig, 1998, Transparency in Government Operations, IMF Occasional Paper No. 158, p. 1.

[41] OECD (2002).OECD Best Practices for Budget Transparency, OECD Journal on Budgeting, Volume 1, No. 3, 2002, p. 7.

# Annex 2 Terms and concepts used

## Automatic stabilisers

Automatic stabilisers are the automatic reactions of public finances to fluctuations in the economic cycle. In a recession, public finances automatically grow weaker as revenues from taxes and charges fall, while expenditures of social-security systems rise. This means that the downturn's effect on household consumption expenditure can be lessened, which moderates the economic downturn. The opposite is true during a boom. Then, public finances are strengthened, which restricts the increase of household income and moderates the economic upturn.

### Budget elasticity

Budget elasticity is a measure of how net lending is affected by a change in the economic cycle. The Government assumes budget elasticity of 0.55. This means that if the economy deteriorates (improves) by 1 per cent of GDP; in other words the GDP gap increases (decreases) by 1 percentage point, net lending deteriorates (improves) by 0.55 per cent of GDP.

### Budget policy framework

The budget policy framework includes the surplus target for public sector saving, the expenditure ceiling for central government primary expenses and expenses related to the old-age pension system, combined with a rigorous central government budget process and a local government balanced budget requirement.

### Budget transparency (definition used by the OECD)

The OECD defines budget transparency as "full disclosure of all relevant fiscal information in a timely and systematic manner".

### Council of the European Union

The Council of the European Union is the EU institution where representatives of member state governments meet; that is all the member state ministers responsible for a particular policy area. The composition of the Council and frequency of its meetings varies depending on the issues being dealt with. For example the economic and financial affairs ministers meet once a month for a council meeting to deal with economic and

financial affairs – the ECOFIN Council. The Council's tasks include adopting legislation (regulations, directives etc.), contributing to coordination of member countries' policies, formulating common foreign and security policy in accordance with European Council strategic guidelines, entering into international agreements on behalf of the European Union and adopting the EU budget together with the European Parliament.

### Employed

People who in a certain week (the reference week) performed some work (at least one hour) either as a paid employee, self-employed or unpaid assistant in a company belonging to a spouse or other member of the same household.

### Fiscal policy framework

In addition to the budget policy framework (see above), the fiscal policy framework refers to a number of principles on which fiscal policy is based and that aim to ensure that fiscal policy is long-term sustainable and transparent. These principles include how fiscal policy should be formulated from a stabilisation perspective, principles for how central government interventions in the financial markets should take place to safeguard public finances and principles for clear and transparent reporting of fiscal policy.

### Fiscal policy transparency (definition used by the IMF)

"Openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections. It involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities so that the electorate and financial markets can accurately assess the government's financial position and the true costs and benefits of government activities, including their present and future economic and social implications."

### GDP gap (or Output gap)

The GDP gap is the difference between actual and potential GDP (see below). The GDP gap is a measure of the total use of resources in the economy and is usually expressed as a percentage of potential GDP. When the GDP gap is positive, demand exceeds the level that is sustainable in the long term in relation to available resources, which creates inflationary pressure in the economy. When the gap is negative, demand is low and there are unused resources in the economy.

### Gross domestic product (GDP)

The value of all final goods and services produced in an economy.

### Hours worked

The total number of hours worked in the economy.

### Medium-term perspective

The fiscal policy bills normally include a projection of macroeconomic trends and public finances for a three-year period. The projection includes a forecast for the current and next years and an "estimate" for the subsequent two years. Since the 2010 Spring Fiscal Policy Bill the Government has decided to add a further year to the projection; in other words the "estimate" has been extended by one year.

### Net lending

Net lending is the difference between revenues and expenditures, according to Statistics Sweden's sector accounts, which are part of the National Accounts.

### Potential GDP

Potential GDP is the level of production at normal use of the economy's productive resources. This means that production can be sustained at this level without upward pressure on prices and wages becoming so strong that the Riksbank's (Swedish central bank´s) inflation target of 2 per cent is exceeded.

### Public sector

The public sector is defined in the National Accounts as the sum of the central government sector, the local government sector (municipalities and county councils) and the old-age pension system.

### Seven-year indicator

The seven-year indicator for a given year (t) is the mean value of public sector net lending in year t–3 to year t+3 adjusted for major non-recurring effects and the effect of extraordinary levels of household capital gains. Expressed as a percentage of GDP.

### Structural net lending (structural balance, cyclically-adjusted net lending)

Structural net lending is a measure of net lending in 'normal' economic conditions. Structural net lending is also adjusted for some major non-recurring effects and the effect of extraordinary levels of household capital gains.

### Surplus target (balanced budget target)

The surplus target is an overall target for fiscal policy. The surplus target means that general government net lending is to be equivalent to an average of 1 per cent of GDP over a business cycle.

The Riksdag has decided that general government net lending is to be an average of 1 per cent of GDP over a business cycle. Since the surplus target is expressed as an average over an undefined period of time, this places great demands on clear and transparent reporting of target fulfilment. Under the Budget Act the Government is to report twice a year on how the surplus target is achieved.

In this audit of the Budget Bill for 2014 the Swedish National Audit Office has dealt with four different aspects of the Government's monitoring of the surplus target: the significance of macroeconomic assumptions for calculating target fulfilment, the Government's reporting and analysis of target fulfilment, the Government's reporting concerning the striking a balance between surplus target fulfilment and conducting stabilisation policy and, finally, the effect of business cycles on public finances.

The Swedish National Audit Office concludes that monitoring the surplus target largely rests on the Government´s assumptions concerning policy effects and that the Government makes no overall statement on how the surplus target is met. Furthermore the reporting in the Budget Bill does not describe sufficiently clearly how the Government´s proposed fiscal policy follows the intentions of the fiscal policy framework. Finally, the Government could increase the transparency of budget calculations by reporting on and giving reasons for assumptions made and methods used concerning budget elasticity.

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Orders:
www.riksrevisionen.se
publikationsservice@riksrevisionen.se
Riksrevisionens publikationsservice
SE-114 90 Stockholm, Sweden

THE SWEDISH NATIONAL AUDIT OFFICE

NYBROGATAN 55, SE-114 90 STOCKHOLM, SWEDEN
+46 8-517 140 00
WWW.RIKSREVISIONEN.SE