

Urban Hansson Brusewitz – Yngve Lindh*

Expenditure ceilings and fiscal policy

Swedish experiences

In the late 1990s the Swedish budget process and fiscal framework were thoroughly reformed, and in 2006 the new system had been in place for eight years. The aim of this paper is to describe this system, with an emphasis on expenditure ceilings, and to discuss the experiences gained so far. The paper is organized as follows: First the reforms of the budget process and the Swedish fiscal framework are presented. Especially, the relation between expenditure ceilings and the surplus target is explained. Then the paper discusses the track record of the expenditure ceilings, describes the budget margin mechanism and the principles for deciding the nominal levels of the ceilings. After that the paper highlights some problems with the system. Then the functioning of

the system over the economic cycle 1998 to 2005 is discussed. Finally, the conclusions are summarised.

DESCRIPTION OF THE FISCAL POLICY FRAMEWORK¹

Budget process and expenditure ceilings

The Swedish public finances went through two weak periods in the last decades – first in the early 1980s and then in the early 1990s. The latter episode was the most severe fiscal crises after the second World War, and probably one of the deepest one in the industrialized world at that time. This pronounced weakening was influenced by the international slowdown, but had without doubt also domestic causes related to stabilization policy, sequencing of deregulation and to the wage formation process. At that time it was also observed that the Swedish budget process was rather loose and could have contributed to the crises.² A reform process was initiated, which led to substantial changes in the budget process later in the 1990s. Central features of the new budget process, implemented in January 1997, are a “top-down” budgetary process, multi-year expenditure ceilings and a medium-term target for the government's net lending.

* Both authors are employed in the Swedish Finance Ministry. *Urban Hansson Brusewitz* is currently Economic and Financial Attaché at the Swedish Delegation to the OECD and former Director, Division for Budget Totals and Coordination of the Budget Process at the Budget Department and *Yngve Lindh* is Senior Economic Adviser, Division for Public Finances, Economic Affairs Department. The views expressed in this paper are those of the authors and do not necessarily reflect those of the Finance Ministry. A first version of this paper was presented and discussed at Banca d'Italia's workshop, “Public Expenditure”, 31 March-2 April 2005. The Swedish fiscal framework was also discussed at the Conference on Fiscal Responsibility, 19 May 2006, arranged by the National Bank of Hungary and the SAO of Hungary.

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The “top-down” budget process assigns a clear role to the Ministry of Finance in drawing up the budget. The multi-year framework includes nominal expenditure ceilings for the coming two or three years. For the two coming fiscal years ($t+1$ and $t+2$) these ceilings are already laid down in decisions of earlier years. The Government's proposal for the new expenditure ceiling three years ahead ($t+3$) is discussed and decided at a cabinet budget meeting in August. The discussion is based on a proposal from the finance minister. The level of the expenditure ceiling for year $t+3$ is presented to the Parliament in the Budget bill in September and is approved by the Parliament in November. The decision is a guideline decision that can be changed by a new decision by the Parliament. A lot of political prestige has, however, been invested in the expenditure ceiling and there are strong political commitments to maintain the ceiling at the decided level.³

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

The ceiling includes central government

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

The surplus target

The fiscal policy framework implemented in the late 1990s includes two targets at the national level.⁵ In addition to the expenditure ceiling there are also surplus targets that cover the general government sector, i.e. the central government, local governments and the old age pension system. The target, which is set for the medium term, is that the general government net lending (according to ESA95) should amount to 2 per cent of GDP per year on average over the business cycle. One indicator of the targets is that the structural surplus (adjusted for the cycle and one-off measures) should amount to 2 per cent of the GDP. Other indicators are averages over periods of several years indicating a cycle.

In practical implementation *ex ante* the medium-term target is translated into an annual target for the actual budget surplus in year t and $t+1$.⁶ This annual target is proposed by the Government in the Budget Bill for the year $t+1$ in September in year t and is approved by

Parliament later in the autumn. The targeted surplus could deviate from 2 per cent of the GDP for two reasons. First, the cyclical situation (measured as the GDP-gap) is normally taken into account when the annual target is set. Secondly, a large initial deviation from 2 per cent could motivate a slower adjustment back to the targeted level than within one year.

The annual targets were fulfilled in the years 2000, 2001, 2004 and 2005. In 2002 and 2003 unexpected weak growth and expansionary fiscal policy contributed to the outcomes. (See Table 1)

The aim of the surplus target

The main motive of the surplus target is to reduce public debt to account for the budgetary impact of an ageing population. Thus, the target is forward-looking. The dependency ratio of the elderly related to the working population will increase rapidly after 2010. To hold a surplus of public net lending at an average rate of 2 per cent, during the coming decade public debt and interest payments will have to be reduced. This will diminish the need to for budgetary retrenchment (e.g. tax increases) when costs for the ageing population starts to rise, and will also smooth the tax burden across generations. The sustainability criterion behind the choice of surplus target is that the debt situation should not deteriorate over a foreseeable period, which is long enough to include the demographical structural change. The esti-

mates presented in the Updated Swedish Convergence Programme 2006 results in a central government ratio 2050 that is lower than today. The calculations include the assumption that the surplus target is reached by 2015.⁷

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

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

Why two targets?

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

Table 1

THE SURPLUS TARGET: ANNUAL TARGETS AND OUTCOME

(Net lending, per cent of GDP)

	2000	2001	2002	2003	2004	2005	2006
Annual target	2.0	2.5	2.0	2.0	0.5	0.5	0.5
Outcome	5.0	2.6	-0.5	-0.2	1.6	2.8	—

Source: Ministry of Finance and Statistics Sweden

There exist several motives behind the system with two targets. First, even if the surplus target promotes long-term sustainability and secure room for automatic and active stabilization policies, it does not constrain the levels of total spending and total tax revenues. However, together with the surplus target, the level of the expenditure ceiling determines an implicit target for the tax level. A separate revenue target is therefore not needed, but a desired tax level could guide the choice of the expenditure ceiling.

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

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

For practical application the expenditure ceilings have advantages compared to the surplus target. The nominal ceilings are highly transparent, a strict ceiling is expressed as a simple figure in SEK, and therefore they are easy to monitor. The experience gained so far shows that this contributes to the political commitment to keep the target and that there are substantial political costs not to do so. Other institutions monitor the ceilings, most strictly the National Financial Management Authority (ESV)⁹. On several occasions in autumn this authority has reported that the ceilings have been threatened and such reports have been published in the media. On such occasions the government has so far always corrected its expenditure policy to comply with

the target. The medium-term surplus target on the other hand is a symmetric target and is less easy to monitor.¹⁰ Measures of structural balances could be used as indicators of compliance but they are notoriously uncertain. Also, the length of the cycle is not a clearly defined concept.

TRACK RECORD OF EXPENDITURE CEILINGS 1997–2004

The level of the expenditure ceiling

General government expenditure as a percentage of the GDP rose sharply during an economic crisis in the early 1990s. In 1993, the expenditure to GDP ratio amounted to 70.4 per cent of the GDP. The savings in the consolidation programme, which was implemented in 1994 and became fully effective in 1998, contributed to a fall in the expenditure to GDP ratio. After the completion of the consolidation programme, the general government expenditure continued to decline as a percentage of the GDP between 1998 and 2000, from 58.2 per cent in 1998 to 54.2 per cent in 2000. This fall in the expenditure ratio was mainly a consequence of relative restrictive levels of the expenditure ceilings these years. As a percentage of the GDP, the expenditure ceiling fell by about 2.5 per cent between 1998 and 2000. During the same period the tax ratio increased by about 1 percentage point, and general government net lending increased from 1.9 to 5.0 per cent of the GDP. Hence, during these years the expenditure ceiling prevented a situation where temporary high tax revenues, due to a cyclical upswing, were used to finance permanently higher spending.

Corrected for technical changes, the expenditure ceiling was set at a relatively stable level of almost 33 per cent of the actual GDP for the period 2000–2004. However, since average eco-

conomic growth has been lower than trend growth during these years the expenditure ceiling as a percentage of the potential GDP has decreased somewhat since 2000. During the same period primary general government expenditure including local governments according to the National Accounts is expected to increase by about 0.8 per cent of the GDP to 52.5 per cent 2004, *see Table 2.*¹¹ The expenditure ceilings have, so far, been effective in restraining the growth of public expenditures and in maintaining a structural surplus in general government finances.

Corrected for technical changes, the expenditure ceiling decreased from 36.2 per cent of GDP in 1997 to 32.5 per cent of GDP in 2005. (*See Table 3*) The ceilings that are now in effect up to year 2008 imply that the expenditure ratio will continue to decline over the next few years.

The budget margin

A critical feature of the expenditure ceiling is that it has an ex post dimension. It should be

implemented in such a way that the outcome of the ceiling-restricted expenditure is below the decided expenditure ceiling. It is not enough that the target is met ex ante when the ceiling is determined three years in advance or at the time of budget approval.

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

Table 2

EXPENDITURE CEILINGS ADJUSTED FOR TECHNICAL CHANGES

(billion SEK)

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005
Expenditure ceiling	702	699	714	723	749	773	803	836	870
Per cent of GDP	36.4	35.3	34.3	32.9	33.0	32.9	32.9	32.8	32.5
Expenditure under the ceiling	678	697	712	718	744	773	800	834	864
Per cent of GDP	35.9	35.3	34.2	32.7	32.8	32.8	32.8	32.7	32.5
Budget margin	24.0	2.0	1.5	5.0	4.7	0.4	2.9	2.4	5.7

Sources: Ministry of Finance and Statistics Sweden

Table 3

GENERAL GOVERNMENT EXPENDITURE

(per cent of GDP)

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005
Expenditure	60.5	58.2	57.2	54.2	53.7	55.3	55.4	53.8	53.5

Sources: Ministry of Finance and Statistics Sweden

served as a planning reserve for future, not yet decided or announced, spending initiatives.

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

Table 2 shows the outcome of budget margins for 1997–2005. We see that the expenditure ceiling was met every year since its introduction in 1997. In 1997 the budget margin was relatively large in relation to the expenditure ceiling. Between 1998 and 2005, however, the outcome of the budget margin was relatively small, just a fraction of a per cent of the expenditure ceiling.¹⁴ The budget margins are expected to be larger between 2006 and 2008.

Since 1998 the budget forecasts for the current year have usually indicated a risk of an overrun of the expenditure ceiling. The reason for this is, among other things, that the new expenditure reforms were decided after the level of the expenditure ceiling was approved and the economic downturn in the economy that began in 2001. This development created a pressure on the expenditure ceiling, mainly through higher than expected unemployment benefits. The small budget margins were also to a large extent caused by higher than expected

costs for sick leave insurance. In 1997 the number of people on sick leave was at a historically low level. In 1998, this number started to increase. This increase was forecasted not to last long. Because the increase from 1997 onwards was not forecasted, it took a long time for the Government to react to it. In 2002, an all-time high was reached. Hence, from 1997 to 2003, the total costs for sickness benefits, including early retirement, rose rapidly. In relation to total ceiling-restricted expenditures the costs for sick leave insurance and disability pensions increased from 11 per cent in 1997 to 15 per cent in 2003.

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

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

reforms or increased the need for budgetary retrenchments in that year.

On some occasions the government has also proposed permanent savings in, e.g. some transfer systems, to comply with the expenditure ceiling. Other measures can also be used. The Government has submitted proposals to the Parliament on exceptions from the normal rule that acquisition of assets of an infrastructural nature shall be financed by appropriations. Instead the Government has, in a few cases, proposed that acquisition of such assets shall be financed by loans in the National Debt Office. This means that accounting in relation to appropriations and the expenditure ceiling takes place in future years when the loans are amortized, and not in the fiscal year to which the investment expenditure relates. Hence, just like in the case with limitation amounts, loan-financed infrastructure projects tend to reduce the level of the budget margin in the coming fiscal years. The Government has also used tax expenditures or net budgeting of fees as a remedy when the expenditure ceilings have been threatened (*see below*).

Principles for the decisions on the expenditure ceilings

When the ceiling for the new third coming fiscal year is to be set, the previously decided expenditure ceilings for the first two years are maintained, unless very strong reasons justify modifications of the ceilings. So far, the ceilings have been maintained at the previously decided level, with the exception for some technical adjustments.¹⁵

Several factors are normally taken into consideration when the level of the expenditure ceiling is determined. One factor is that the expenditure ceiling affects the scope for tax reforms or the need for tax hikes over the medium-term. The desired level of future tax

reforms should therefore be taken into consideration when the ceiling is proposed. Equation 1 illustrates the relation between the desired level of tax reforms for year $(t+3)$, ΔT_{t+3} , and the level of the expenditure ceiling, C_{t+3} .

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

where R_{t+3} denotes projected general government revenues assuming unchanged tax rules for year $(t+3)$ ¹⁶, S is the desired structural level of general government net lending (2 per cent of the GDP), and OE_{t+3} is projected net expenditures outside the ceiling (mainly projected local government expenditures and interest on central government debt). The level of ceiling-restricted expenditures that are compatible with the planned tax measures then equals $R_{t+3} + \Delta T_{t+3} - S - OE_{t+3}$. By adding an appropriate budget margin (M) one obtains the desired level of the expenditure ceiling.

The difference between the maximum planned expenditure level that follows from the expenditure ceiling ($C_{t+3} - M = R_{t+3} + \Delta T_{t+3} - S - OE_{t+3}$) and a consequent assessment of how large expenditure will be for the coming third year (if measures already decided are implemented), then show the potential scope for expenditure reforms for that year.¹⁷ If this difference is negative there is instead a need for budgetary retrenchments on the expenditure side of the budget.

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

A problem with the top-down method of determining the level of the expenditure ceiling in Eq. 1 is that it requires information on the

desired future tax reform and the budgetary impact of such reforms. Because of this problem the expenditure ceilings have also been determined on the basis of other factors and considerations. One is the relation between the expenditure ceiling and the GDP. As mentioned above, the expenditure ceiling has since year 2000 been set at an approximately constant level of the GDP. For a given level of the surplus target and local government expenditures this means that the government planned for an approximately constant level of the overall tax burden over time when the expenditure ceilings were determined.¹⁸ It has also been seen important to avoid a trend growth in the expenditure ratio during the current decade because of the future budgetary impact of ageing populations after year 2010.

PROBLEMS

A drawback with hard budget constraints is that they might encourage the use of dubious accounting practices, thereby reducing the degree of transparency in the government budget.¹⁹ Normally, such operations give the government some margin of flexibility in the implementation of the fiscal rule. In the case of Sweden, with a rule on the aggregate level of central government spending, the easiest way to circumvent the expenditure ceiling is to introduce net accounting or subsidies on the revenue side of the budget (tax expenditures).

As a rule, the Budget Act prescribes that the state budget shall, in principle, include all government revenue and expenditure, and that revenue and expenditure shall be entered gross in the state budget. However, the Parliament may decide on exceptions from these rules. This has occurred on a few occasions when the Government has been given authority to decide on the disposition of certain revenues from user-fees. This means that related expenses are

no longer accounted for in the state budget. The effect of these operations on ceiling-restricted expenditures has, however, been relatively small and the proposals have been presented to the Parliament in a transparent way.

Another potential problem related to the expenditure ceiling is the use of tax expenditures. Tax expenditure exists if there is a deviation between the tax system and a certain benchmark or norm. In Sweden tax expenditure estimates have been published annually since 1996 in the Spring Fiscal Policy Bill. The report covers most types of taxes, for example, the national and the local personal income tax, the corporate income tax, social security contributions and most indirect taxes. More than 150 different tax expenditure items are included in the report. Currently, total reported tax expenditures amounts to about SEK 250 billion or about 8 per cent of GDP. Some of these tax expenditures are very close substitutes to ordinary expenditures, e.g. the so called employment support that is paid to local governments by crediting their tax accounts. Tax expenditures that can be directly compared to public expenditures amounted to about 0.4 per cent of GDP in 2005.²⁰ Other tax expenditure items are less close substitutes to ordinary expenditure. Theoretically, proposals for new tax expenditure items, that take place after the level of the expenditure ceiling has been set, should be accompanied by a proposal for a downward technical adjustment of the ceiling. However, because of the varying degree of substitutability between tax expenditures and ordinary expenditures it is difficult to establish unambiguous rules for such technical adjustments. Hence, new tax expenditures have not usually been followed by a proposal for a technical adjustment of the expenditure ceiling. Small budget margins under the expenditure ceiling have led to increased pressure for tax expenditures. This pressure has, however, to some extent been held back by the surplus target.²¹

Hard budget constraints might increase the temptation to present biased expenditure and revenue forecasts. By strategically manipulating the budget assumptions, the government can abide by the law and then have a list of explanations as to why the targets were missed ex-post. The risk of a political element in budget forecasting can probably be reduced if the government is committed to meet the fiscal rule both ex-post and ex-ante and if independent agencies outside the Government Office monitor the budget and produce independent budget forecasts. Currently there are three domestic bodies outside of the Government Office that monitor budget execution and produce independent short term and medium term forecasts of central government finances.²² Naturally, the Swedish public finances are also monitored by the EU Commission and the Council in the context of SGP. Since these forecasts are made public it may be hard for the Government to present budget forecasts that differ too much from the external forecasts without presenting a clear motivation for the deviation.

THE FISCAL FRAMEWORK IN DIFFERENT CYCLICAL SITUATIONS

In the period after the expenditure ceilings were introduced in 1997 the Swedish economy roughly experienced a full business cycle. The period 1998–2000 included “good years” with an average growth rate of 3.8 per cent per annum and a positive *output gap* in 2000. On the contrary, the period 2001–2003 was economically weaker. The average GDP growth rate amounted to 1.5 per cent of the GDP with the largest negative output gap in 2003, approximately 1.5 per cent of the GDP. 2004 and 2005 were again years with higher growth, above 3.0 per cent on average. The profile of the cycle did not diverge much from those of most other countries in the European Union, although the average growth

rate over the whole period was somewhat higher compared to the European average.

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

Expenditures in the boom 1998–2000

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

In addition to a sustained growth and low unemployment in this period, inflation was moderate. On averages CPI rose by only 0.4 per cent per annum. Compared to the forecasts and projections in the *Budget Bill for 1998*, growth developed 1.0 per cent faster per annum and CPI-inflation turned out to be 1.3 per cent lower per annum. As several transfers in the Swedish system are indexed to the development of CPI (with a lag) low inflation mitigated the pressure on the ceilings. This development was also reinforced by the budget effects of declining unemployment. At the same time, budget margins reserved for cyclical effects on the budget in “bad times” were more or less fully used up. These margins appeared to be soft restrictions and constituted a weak

part of the framework. Altogether, there was room for discretionary, and to some extent permanent increases in non-cyclical expenditures. Examples were increased expenditures for *education and research* and *economic security for families and children*. The pressure on higher expenditures was, however, also reinforced by the substantial increase in expenditures for *economic security in case of illness and disability*, i.e. the sick leave insurance and early retirement schemes between 1998 and 1999 and after that their trend-wise growth up to 2003, see also Section 3.²³

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

The slowdown in 2001 to 2003

In the weak economic situation that lasted from 2001 through 2003, surpluses deteriorated from approximately 5 per cent of the GDP to just around balance. Roughly two thirds of the deterioration was contributed to discretionary fiscal policy measures and one third to automatic adjustments. In the first two years of the slowdown fiscal policy was strongly expansionary including both tax cuts amounting to approximately 2 per cent of the GDP and increased expenditures by around 1 per cent of the GDP. In 2003, the last year in the prolonged slowdown, the fiscal stance turned less expansionary and included only modest expenditure increases (0.2 per cent of the GDP).²⁴

The pressure on the ceilings for cyclical reasons was not that hard in 2001 and in the election year 2002, but grew stronger in the two successive years. This reflects the lagged effect on expenditure of the low CPI-inflation in ear-

lier years and that unemployment only increased late in the slowdown. In these years, there were two other distinct factors behind the pressure on the margins. First, as was mentioned above, active expansionary fiscal policy was substantial and was partly executed on the expenditure side of the budget. Major expenditure increases were directed towards increased *child allowances, education and research, health care, schools and social services*, the latter by increased grants to local governments. Most of these expenditure increases must be seen as permanent measures. Second, the costs for illness insurance and early retirement schemes grew rapidly in a trend-wise and non-cyclical way. It is also notable that expenditures related to labour market policy (a semi-automatic stabilizer) did not increase as could be expected in the slow-growing economy, not even in 2003 when unemployment clearly picked up. An interpretation could be that automatic stabilizers on the expenditure side of the budget were hampered by pressure on the ceilings by margins used up for other reasons.

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

REFLECTIONS AND CONCLUSIONS

A first reflection is that the Swedish reform in the late 1990s was a typical example of how a severe economic and budgetary crisis made a reform necessary.

A general conclusion is that the nominal expenditure ceilings have functioned well. First, in the period 1997–2005, i.e. for nine years, the Government complied with the ceilings. The expenditure ceilings helped the Swedish Government eliminate its deficits and stabilize public finances. Between 1997 and

2005 the expenditure ceiling contributed to a fall in the general government expenditure ratio from 60.5 to 53.5 percent of the GDP. The new process with expenditure ceilings is also felt to have increased long-term thinking, because decisions on the expenditure ceilings are taken early in the process.

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

small in relation to the total expenditure level. Finally, a very important issue is the attitudes or values that the policy-making establishment holds towards public finances. Our interpretation of the development is that before the middle of the 1990s, rapidly expanding public expenditure, increasing tax ratio and substantial deficits were not perceived as major economic or policy problems by the political establishment. The threatening financial crisis of the central government in the beginning of the 1990s, however, made it obvious that the development and performance of our public finances did matter. The lesson learned was that a political majority is also subject to fundamental economic and financial laws. That lesson has not yet been forgotten.

NOTES

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

² Molander (2000).

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

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

⁵ Added to the targets on national level there is also a balanced budget requirement for local governments.

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

⁷ For more detailed presentations of assessments of long-term sustainability of Swedish public finances and their relation to the surplus target, see the Budget Bill for 2007, Appendix 2, "Sweden's Economy" (chap 13) and the Swedish Convergence Programme 2006.

⁸ Empirical estimates show that the so called semi-elasticity measuring the budget sensitivity with respect to the output gap is approximately 0.7 while it is 0.5 on average in the EU15.

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

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

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

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

- ¹³ To understand the principles for the decisions on the ceilings, see the Principles for the decisions on the expenditure ceilings
- ¹⁴ This was however not the case for 2005 and 2006.
- ¹⁵ Such adjustments have been made several times due to policy changes that have affected the ceiling-restricted expenditures without affecting the consolidated expenditures of the general government sector. After the technical adjustment of the expenditure ceiling the margin between the new ceiling and ceiling-restricted expenditures should in principle be the same as before the change that gave rise to the adjustment.
- ¹⁶ When the level of the expenditure ceiling for the third coming year is to be determined, the output-gap is normally assumed to be approximately zero for that year. Hence, the tax forecast for year $t+3$ normally shows expected tax revenues collected at the potential level of GDP. This means that a calculation of the level of the expenditure ceiling made in accordance with Eq.1 is based on tax revenues obtained at the potential level of GDP. Higher tax revenues than expected due to a cyclical upturn (resulting in a positive output gap), will therefore be used to improve the budget balance (given that the expenditure ceiling is a more or less binding constraint).
- ¹⁷ This difference also equals the difference between the projected budget margin, which follows from the consequence assessment, and the contingency reserve.
- ¹⁸ Surpluses well above 2 percent in 2000 and 2001, however, gave room for tax cuts.
- ¹⁹ This is for instance discussed in Kopits (2001) and Milesi-Ferretti (2001).
- ²⁰ In accordance with the generally accepted accounting practice in the Central Government's Annual Report. In the Budget Bill for 2007 this type of tax expenditures is planned to be substantially reduced for the period 2007–2009.
- ²¹ Tax expenditures have also been discussed in Boije (2002).
- ²² The National Debt Office publishes forecasts of the central government's borrowing requirement for the current year and the coming fiscal year. The National Financial Management Authority publishes medium-term forecasts of central government revenues and expenditures (as well as ceiling-restricted expenditures) about four times a year. The National Bureau of Economic Research quarterly publishes medium-term forecasts of central and general government net lending as well as forecasts of ceiling-restricted expenditures.
- ²³ Spring Fiscal Policy Bill 2004
- ²⁴ Sweden's updated Convergence Programmes 2001 to 2004