RIKSREVISIONEN
The Swedish National Audit Office

RiR 2010:14 Summary

Application of the framework of fiscal policy: The government´s presentation in the 2010 Spring Fiscal Policy Bill

Summary

Fiscal policy in Sweden is governed by three comprehensive targets:

- corresponding to 1 per cent of GDP on average over a business cycle;
- The expenditure ceiling for the central government entails that the spending of the central-government sector is restricted by an amount in SEK billion decided three years in advance;
- The balanced-budget requirement means that individual municipalities and county councils must not adopt budgets where expenditures exceed revenues;
- The surplus target requires the net lending of the general government sector to show a surplus.

Riksrevisionen (the Swedish National Audit Office, SNAO) regularly audits the Government's application of this fiscal-policy framework in the fiscal bills. The aim is to contribute to a comprehensive and clear presentation of fiscal and budgetary policies to the Riksdag (parliament) and the general public. A transparent presentation of the orientation of fiscal policy in relation to the budgetary targets strengthens confidence in fiscal policy and contributes to a stable economic development.

In the Budget Bill for 2007, the Government announced its intention to review the fiscal-policy framework, which had then been in use for just over ten years. As a result of that review and ongoing improvement efforts at the Ministry of Finance, the presentation of fiscal policy has improved in several respects over the past few years. The establishment of the Swedish Fiscal Policy Council in 2007 has also led to increased external monitoring. The Council recently published its third report.

The Swedish economy was hit relatively hard by the international crisis, with a large fall in GDP and increased unemployment. The Government's forecasts in the Spring Fiscal Policy Bill now point to a marked recovery. However, uncertainty about economic trends has recently increased again because of the problems in the public finances of several EU countries.

From an international perspective, Sweden's public finances are in good order. Developments both in Sweden and in other countries show that a well-designed fiscal-policy framework enjoying strong political support is of great importance in ensuring stable public finances. To maintain confidence in public finances at a time of uncertainty, it is particularly important that the Government should present its monitoring of compliance with the budgetary targets and its strategy to meet the surplus target in an exhaustive and transparent manner.

This report deals with four aspects of the Government's presentation in the 2010 Spring Fiscal Policy Bill: the expenditure ceiling, the finances of the local-government sector, potential GDP and the sustainability of fiscal policy.

Expenditure ceiling

Observations and conclusions

The expenditure ceiling is the key tool to ensure that the surplus target is met and that public finances are long-term sustainable. The Government's estimates and its proposals for expenditure ceilings should therefore be based on transparent and explicit reasons linking them both to the surplus target and to the desired level of taxation. In the Spring Fiscal Policy Bill, the Government presents what it deems to be appropriate expenditure ceilings for both 2013 and 2014, i.e. for one year longer than normal. For both of these years, the Government's estimates of appropriate ceilings entail a very large margin between the expenditure ceiling and the spending forecast (SEK 64 billion and 56 billion, respectively). This is true both in relation to the size of the margins of uncertainty that the Government deems necessary and in relation to the surplus target. Like in previous bills, the reasons given for the proposed expenditure ceilings include no explicit analysis of how each ceiling relates to the surplus target and the desirable level of taxation.

In its audit of the Budget Bill for 2010, the SNAO pointed out that the proposed expenditure ceiling for 2012 created a budgeting margin of almost SEK 50 billion, which exceeds the Government's stated benchmark for the margin of uncertainty by about SEK 20 billion. The Government now predicts that the expenditures restricted by the ceiling will be substantially lower. As a result, the budgeting margin in 2012 increases to just over SEK 70 billion, which is far more than in any previous year since the expenditure-ceiling system was put into use in 1997. The margin in 2011 is forecast to be just over SEK 50 billion.

No adjustment to the expenditure ceilings is announced in the Spring Fiscal Policy Bill.[1] In practice, this means that the expenditure ceiling will not restrict spending in 2011 and 2012. The Government stresses that the expenditure ceiling for 2014 is the primary factor restricting the scope for permanent reforms in 2011 and 2012. The Government also emphasises that the scope for reform on the expenditure side in those years is restricted by the surplus target rather than by the expenditure ceiling. However, because of the lack of precision and clarity that characterises monitoring of compliance with it, the surplus target is a significantly weaker restriction than the expenditure ceiling. The large budgeting margins deprive the expenditure ceiling of its role as a tool to ensure compliance with the surplus target and maintain the strictness of the budgetary process in a period of particularly great uncertainty about the restoration of stability in public finances.

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[1] Proposals to modify previously decided expenditure ceilings are normally presented in the Budget Bill.

Recommendations

- The expenditure ceilings for 2011 and 2012 should be adjusted to ensure that they will provide effective support for the surplus target.
- Explicit reasons, taking as their starting point the surplus target and the orientation of tax policy, should be given in support of the proposed expenditure ceilings for 2013 and 2014.

Local-government finances

Observations and conclusions

The local-government sector accounts for about 20 per cent of the national economy and provides the majority of the tax-funded welfare services. To ensure responsible financing, the Local Government Act (SFS 1991:900) requires individual municipalities and county councils to display 'sound financial management' of their operations. That Act also prohibits municipalities and county councils from adopting budgets where expenditures exceed revenues (the 'balanced-budget requirement').

In its audits of the 2009 Spring Fiscal Policy Bill and the Budget Bill for 2010, the SNAO pointed out shortcomings in the reporting of the finances of the local-government sector. This reporting has improved in several respects while the shortcomings remain in others.

The Government's assessment of the finances of the local-government sector focuses on the balanced-budget requirement as a financial target for municipalities and county councils. However, the fundamental requirement of the Local Government Act is for operations to be characterised by 'sound financial management', which normally goes beyond meeting the balanced-budget requirement. By aiming for sound financial management of their operations, municipalities and county councils will create a margin of clearance relative to the balanced-budget requirement, helping to eliminate the risk that they will be forced to make cuts during recessions when their tax revenues fall.

One issue addressed in the audit of the Budget Bill was the handling of the new principles for reporting public consumption in the National Accounts. The forecast of consumption volume is largely based on demographic trends in various age groups. The forecast of cost volume (input of resources) is instead drawn up with regard to the balanced-budget requirement. The fact that forecasts of the consumption and spending volumes are generated differently creates a risk that an assumption about productivity will be introduced into the forecasts 'by the back door'. Indeed, the local-government productivity figures presented in the Spring Fiscal Policy Bill differ between years without any explanation being given.

Comparisons with the previous forecast of the real and financial development of the local-government sector are made only exceptionally. However, such comparisons and explanations for any revisions are of great value in the interpretation of forecasts and should therefore be a normal component of the presentation.

Recommendations

- The basis for forecasts of local-government consumption volume should be clarified;
- Cost volume should be presented together with consumption volume. Reasons should be given for any productivity developments inherent in forecasts;
- Comparisons with the previous forecast and explanations for any revisions should be included in the presentation of forecasts.

Potential GDP

Observations and conclusions

'Potential GDP' is defined as the level of output that can be sustained at normal use of the productive resources of an economy. If actual GDP exceeds potential GDP, the economy is booming. Inversely, the economy is in a slump if GDP is below the potential level of output.

The difference between actual and potential GDP is called the 'output gap' and is used as a rough indicator of the economic situation. The output gap is also used in monitoring of compliance with the Swedish surplus target: one of the Government's compliance indicators is the 'structural surplus' of the general government sector, which is calculated as net lending adjusted for the business cycle.

Despite the importance of the output gap both in the reporting of economic trends and in the monitoring of compliance with the surplus target, however, the description of how the forecast of potential GDP is generated is very brief. There are also no explanations given for the relatively large changes in estimates of the potential level of output between forecasting occasions. One particular problem is that potential GDP is not included in official statistics, meaning that it is not possible to evaluate the precision of forecasts ex post. This makes it even more important that the presentation of the forecasts should be transparent.

Recommendations

- The forecast of potential GDP should be presented in greater detail;
- Any changes in the estimate of potential GDP compared with the previous forecast should be explained, and any differences compared with other forecasters' estimates should be commented on.

Sustainability of fiscal policy

Observations and conclusions

One overall aim of the fiscal-policy framework is to contribute to long-term sustainable public finances. It is therefore important that the analysis of sustainability should be transparently presented, with explicit links to the medium-term budget forecast.

Long-term scenarios and analyses of the long-term sustainability of fiscal policy have been given increasing room in fiscal bills over the past few years. Such estimates are also presented in the convergence programmes submitted to the EU in the framework of the Stability and Growth Pact. All in all, this expanded presentation of both estimates and the methods and models used to generate them is a good thing.

However, the SNAO's audit of the Budget Bill for 2010 criticised the lack of transparency in the design and interpretation of the long-term scenarios. This criticism is still valid. Both the scenarios presented and the conclusions drawn as regards sustainability are difficult to interpret. Among other things, it is in certain cases assumed that the finances of the general government sector will develop in an implausible manner, with a continuous build-up of financial assets eventually reaching more than 100 per cent of GDP. No guidance can thus be derived as regards the appropriate orientation of fiscal policy in the medium term.

Recommendations

- The presentation and analysis of the sustainability of fiscal policy should be further developed;
- A great deal of attention should be devoted to making the presentation easy to understand and to explaining the linkage between the sustainability analysis and the medium-term orientation of fiscal policy;
- The indebtedness of the general government sector should be given more space in the presentation of sustainability.