



## Summary:

# Transparency in the Budget Bill for 2016 – Application of the fiscal policy framework

The Swedish NAO has audited the transparency and clarity of the Government's reporting of fiscal policy in the Budget Bill for 2016. The audit focuses on five issues: Follow-up of the surplus target, what are the underlying assumptions behind the reported budget consolidation during the calculation period, considerations concerning fiscal policy in a longer perspective, the effects of increased migration on calculations of potential GDP and clarity in accounting for budgetary effects.

## Audit background

The Swedish NAO has regularly audited the budget bills. The purpose has been to study the Government's accounting in view of the fact that the budget bills constitute an important basis for Riksdag decisions. This requires the accounting to be clear and transparent. Moreover, it is important that the Government provides well-founded proposals for Riksdag decisions.

This time the Swedish NAO has audited the clarity of accounting for some current issues in the 2016 Budget Bill. In view of the fact that a parliamentary committee is investigating the general government net lending target, the Swedish NAO has extended the audit to include a study of how fiscal policy has been formulated and how the balance between stabilisation policy motives and the surplus target has been considered over a long period of time.

## Audit findings

### *Surplus target not achieved despite optimistic assumptions*

In the 2016 Budget Bill the Government estimates that general government net lending deviates from the target level. The Government does not present any plan for how a return to the target level decided by the Riksdag is to be achieved, which it should do under Chapter 2, Section 1 a of the Budget Act. The Government states that it is important to take into account that there are unused resources in the economy. Since the deviation from the surplus target is considered to be large, in the Government's opinion a return to the current target level in the current electoral period could jeopardise economic recovery. The Government's consideration means that fiscal policy by and large is neutral and that general government net lending remains at the same level in 2016 as the previous year.

Instead of active contractionary fiscal policy measures the Government relies on the automatic contraction generated by the budget regulations to approach the surplus target. The effect used is that in the budget estimates public expenditure is growing slower than income. This effect arises under certain given circumstances, but the Budget Bill states that these conditions only arise in the period 2018–2019. Before that, volume increases in various welfare systems crowd out the budget consolidating effect.

The fulfilment of objectives, or as in the Budget Bill for 2016, moving closer to the target level, builds on good growth while reducing some groups' real remuneration by allowing nominal amounts to remain unchanged. However, historical experience is that the nominal amounts are adjusted from time to time. To improve transparency concerning how the budget improvement arises the Swedish NAO has divided the budget estimates into four; volume growth, real remuneration, changed relative prices and GDP growth. The Swedish NAO's analysis is based on Statistics Sweden's population projections and the Swedish Association of Local Authorities and Regions' cost profile for different age groups. In all about 50 per cent of total general government expenditure was included in the analysis.

The Swedish NAO's estimates, based on the Government's assumed expenditure growth at total level, show that volume growth increases the expenditure share of GDP by 1.6 percentage point during the forecast period. That is a higher level than in any of the previous four-year periods studied. However, volume growth is offset by the assumption that GDP growth will be high. A smaller contribution to improved public finances is obtained through a fall in real remuneration in the benefit systems. Such changes have

taken place in individual areas during certain periods but at total level (that is the 50 per cent of total budget expenditure studied) they are rare.

The Government's expenditure estimates and budget consolidation rest on strong growth and reduced real remuneration. If growth and real remuneration in the benefit systems instead developed in line with the average for the 2000s, according to the Swedish NAO's analysis this would lead to an increase in expenditure as a share of GDP equivalent to most of the improvement in the structural budget balance expected by the Government.

### *Follow-up of the surplus target should be tightened*

The follow-up philosophy advocated in the fiscal policy framework means that several different indicators are weighted together in an overall assessment. In recent years the Government has assigned greater weight to the forward-looking follow-up. The approach entails focusing fiscal policy on achieving the target level in individual years in the forecast period rather than on an average over an economic cycle. A forward-looking follow-up of the surplus target, given the assumption of full utilisation of resources at the end of the forecast period, almost always leads to achievement of the target level at least for the last year of the forecast period. This means in practice a deviation from the Riksdag's approved target formulation. To achieve the Riksdag's target, in the opinion of the Swedish NAO fiscal policy must be formulated to take into account historical deviations from the target. The Swedish NAO therefore notes that the practical application of the fiscal policy framework does not ensure that the surplus target will be met as formulated by the Riksdag.

In the opinion of the Swedish NAO, the follow-up and calculation of target deviations should be tightened and be more mechanical. That would increase transparency of fiscal policy considerations. However, it does not follow from this that the formulation of policy to compensate for deviations should be mechanical. There should be degrees of freedom to formulate effective fiscal policy that contributes to high growth and employment. In cases where the Government does not consider it to be economically effective to try to achieve the surplus target this should be clearly stated.

### *Fiscal policy considerations in a longer perspective*

An overall picture of the fiscal policy framework is that it has served its purpose well. Sweden has had good order in its public finances since the end of the 1990s. During the financial crisis Sweden stood out as a good example when many countries in Europe were suffering disorder in public finances and were forced to make severe cuts in times when from a purely cyclical perspective the economy needed stimulation.

Yet the surplus target has not been achieved. In the past ten-year period general government net lending was 0.2 per cent of GDP, far below the target of one percent over an economic cycle. Moreover, Sweden's general government net lending fell during the period 2010–2015, a period when almost all other EU countries improved their general government net lending.

The Swedish NAO has studied how fiscal policy is formulated in the Budget Bills since 2002. On these 15 occasions the overall direction of fiscal policy for the following year was contractionary on three occasions and expansive on 12 occasions. When we restrict ourselves to the direction of fiscal policy via active fiscal policy the budget has only been contractionary twice (one of these occasions was in 2015 when the Government's budget was defeated in the Riksdag and the opposition's budget was adopted).

In practice the Government takes greater account of stabilisation policy than is described in the framework. According to the framework the Riksbank bears the main responsibility for stabilisation policy and fiscal policy is to be directed towards achieving the fiscal policy targets unless the economic cycle is deviating too much from normal.

All in all, the working method means that fiscal policy seldom requires tightening. The Framework for Fiscal Policy (Govt. Communication 2010/11:79) describes how deviations from the surplus target should be dealt with. When the Government assesses that the target is being achieved no measures are to be taken. If the Government decides that the target is not being achieved at the same time as resource utilisation is low no balance reinforcement measures should be taken until the state of the economy has improved. However, the Ministry of Finance has never publicly reported its position on the definition of low or normal resource utilisation. In the Budget Bill for 2016 resource utilisation is, however, described as low when the GDP gap for 2016 is estimated to be -0.6 per cent of GDP. At the same time, some other commentators believe that the GDP gap is around zero. The European Commission considers that a GDP gap of between -1.5 and 1.5 per cent reflects a normal state of the economy.

One conclusion is that the practical handling of the regulations seldom leads to a contractionary fiscal policy. The Swedish NAO's opinion is that if the surplus target is to be met in accordance with the Riksdag's definition, fiscal policy must be contractionary more often and sometimes of greater magnitude than has been the case in the past 15 years. The best conditions for such a policy exist in economic upturns when unemployment is not too far from equilibrium. The Swedish NAO notes the EU's, IMF's and Swedish Fiscal Policy Council's assessment that consolidation of the structural budget balance by 0.5 per cent of GDP in normal cases is not in conflict with stabilisation policy when the economy is in a recovery phase.

### *The influence of migration on potential GDP*

Starting in 2012 the number of asylum seekers increased. In 2014 the number rose by 50 per cent compared with the year before. In autumn 2015 the growth in numbers was extreme and in the second half of the year about 134 000 people sought asylum in Sweden. The Swedish NAO has studied how migration affects the Government's assessment of potential GDP. The starting point was the decision-making status when the Budget Bill was formulated; thus summer 2015 before the severely increased refugee flow.

The background is that unemployment among people with only compulsory school level education has doubled in the 2000s and it is particularly high among people born outside Europe. In terms of the entire population, the employment level is only 35 per cent for people with only compulsory school level education, while it is 70 per cent for people with upper secondary education and 78 per cent for people with post-secondary education.

The question is what a strong inflow of people, probably with a low educational level, will mean for employment and thus ultimately for potential GDP. A relatively large number of people who previously arrived from the countries that are now predominant in the refugee flows have a low level of education. About 40 per cent of that group can be expected to have only compulsory level education, which can be compared with less than 11 per cent among people born in Sweden.

The Ministry of Finance assumes in its calculations of potential GDP that newly arrived immigrants have the same level of education and will achieve the same employment rate as people who immigrated from the same regions in 2010–2013. According to Statistics Sweden's population projections the group of people born outside Europe aged 25 to 64 will grow by just over 250 000 in the period 2014–2019. If the proportion with compulsory level education is 40 per cent, this corresponds to about 100 000 people. This would mean that the group of people born outside Europe aged 25 to 64 with only compulsory level education would increase by almost 70 per cent to 2019. Since this is the group that finds it most difficult to become established in the labour market there is a risk that an even smaller percentage of that group will find employment as the group is growing rapidly.

If the Government overestimates potential GDP it will mean that the GDP gap and structural budget balance will be overestimated and that growth will be overstated in the budget calculations. A greater GDP gap means stabilisation policy considerations will have greater weight at the expense of the surplus target. All else equal, fiscal policy will be more expansive and the possibilities of meeting the surplus target fewer.

There is a material risk that the large increase in people born outside Europe with only compulsory level education will have a negative effect on the already high unemployment and low employment rate in this group when it increases substantially in size. In this light there is reason for the Government to investigate more closely the reasonableness of the assumption that new arrivals with a low educational level will find employment to the same extent as those now active in the labour market.

### *Reporting of budget effects*

Reporting in the Budget Bill is extensive and the information in the various sections of the Bill may serve different purposes. Clear reporting in the Budget Bill therefore assumes that its purpose and context are apparent to the reader.

The Swedish NAO has previously recommended that the Government reports the budget effects in a fixed set of tables and in view of this has audited the traceability between tables in different parts of the Budget Bill for 2016.

The starting point for the audit is the annex to the Budget Bill for 2013 in which the Government reported how new policy is presented in the Budget Bill and how different sections are interconnected. The audit has been restricted to measures on the revenue side of the budget.

The Swedish NAO finds that the introductory reform table has been changed in relation to the previous year and that traceability to the overall reporting in section 9 has been made more difficult. A complicating factor in that context is the arithmetical transfer to households that the Government uses in the Budget Bill.

Sometimes tables contain no reference to underlying sections or the references in the tables are to sections where it is not easy to derive the basis for the data in the table. The labelling of measures is also sometimes inconsistent, which may make comparisons between Bills difficult. To be able to understand the significance of the Government's plan, in section 5, to strengthen net lending, the reader is assumed to have read and understood other parts of the Budget Bill where the relevant information can be found.

## Recommendations

The Swedish NAO makes the following recommendations to the Government

- Follow-up of the surplus target should be historical. Fiscal policy should be formulated to take into account historical deviations from the target. Fiscal policy must more often be contractionary to meet the surplus target.
- Part of budget consolidation in the Budget Bill depends on assumptions of reduced real remuneration in the benefit systems. The Government should be clearer about the consequences this will have for real welfare growth during the calculation period.
- When calculating potential GDP, the Government should investigate more closely the reasonableness of the assumption that the large number of newly arrived immigrants with a low educational level will be employed to the same extent as previous arrivals.
- The Swedish NAO urges the Government to continue to develop reporting in the Budget Bill and to refrain from using the item arithmetical transfer to households.