Chapter 11

The budgetary policy framework in Sweden and its implication for intergovernmental fiscal relations

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This chapter provides an overview of the Swedish budgetary policy framework with special attention to the local level. The financial crisis that hit the Swedish economy in the early 1990s was a trigger for several political and structural reforms. The reform of the budgetary policy framework, which is part of the fiscal framework, had a great impact on the central and local level. The reforms had large support from society and during the last financial crises starting in 2008 support grew even stronger together with a lot of international recognition. For the local level the balanced budget requirement is the anchor. There are no sanctions involved if budgets are not balanced but most municipalities and county councils have reached the target. During the last years the central government surplus target has been hard to reach and a debate has started to change it to a balance target.

1. The local government sector in Sweden

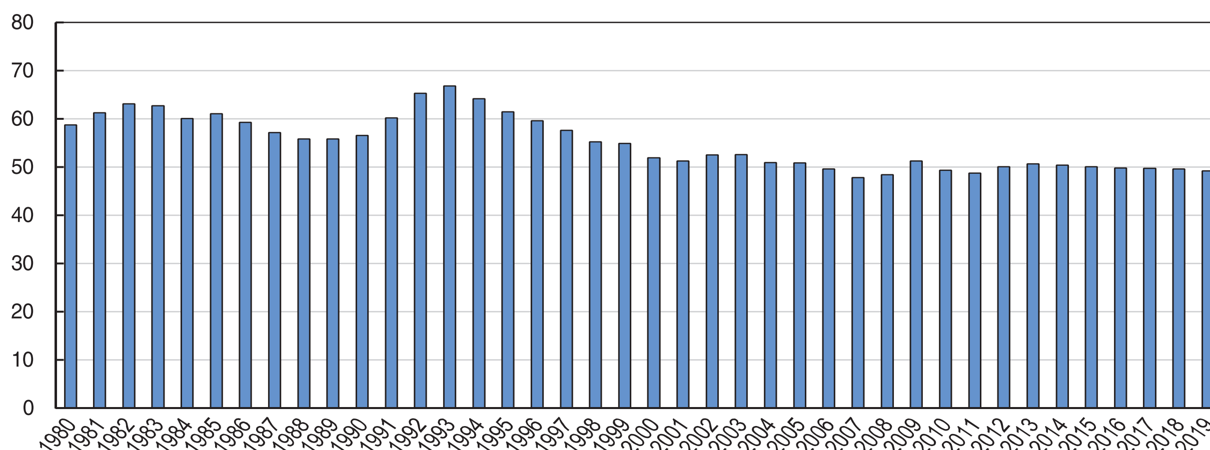
Sweden is divided into 290 municipalities and 20 county councils/regions and they play an important role in carrying out welfare services. There is no hierarchical relationship between municipalities, county councils and regions and they have the right to levy their own taxes. Local and regional self-government is an important element in the democratic system and is written into the Swedish Constitution. Self-government has a long tradition going back as far as 1862. Most of the tasks of municipalities and county councils are regulated in special legislation (e.g. the Social Services Act and the Health and Medical Services Act). The Swedish public sector measured by spending in relation to GDP is over 50% and the major part is carried out by local government. The local government sector employs roughly 25% of the total workforce in Sweden, a majority of them women.

2. Don't waste a good crisis

The level of public expenditure is high today but it has been even higher in the past. When the financial crisis in the early 1990s hit, the expenditure level was around 70% of GDP (Figure 11.1). The crisis was the result of an overheated economy, a fixed exchange rate together with high inflation and a bubble on the real estate market.

Figure 11.1. Public sector expenditure

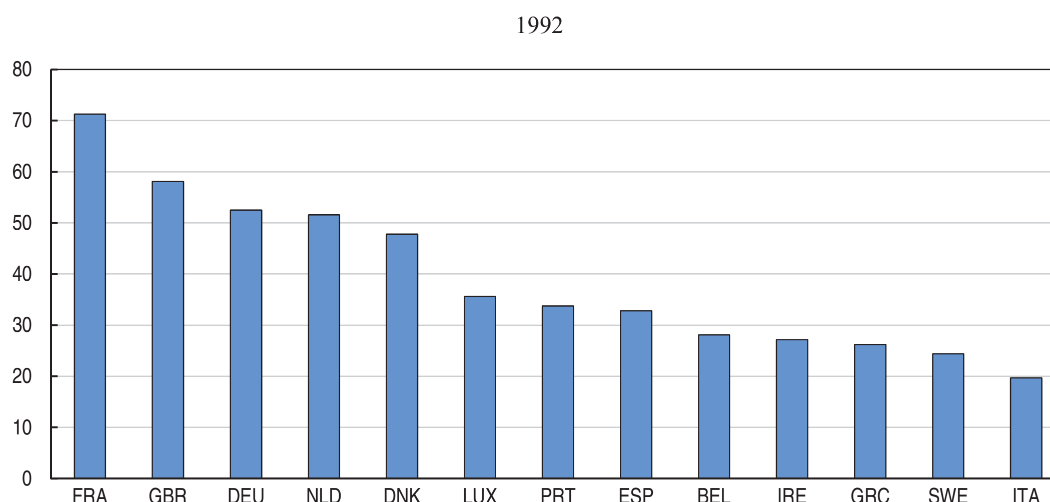
In per cent of GDP



It was clear to the civil servants in the Ministry of Finance that the problem to solve was how to control public spending when the economy was in good shape. One important piece for the new fiscal framework was a study published in 1992 comparing the budget frameworks in different European countries. (Molander, 1992). In the report the budget processes for the 12 member states of the European Union and Sweden was benchmarked. The report showed that Sweden had a weak budget process in line with Greece and Italy. The study and the recommendations had a major impact on the new budgetary policy framework (Figure 11.2).

Figure 11.2. Structural index of the strength of the budget processes

1992

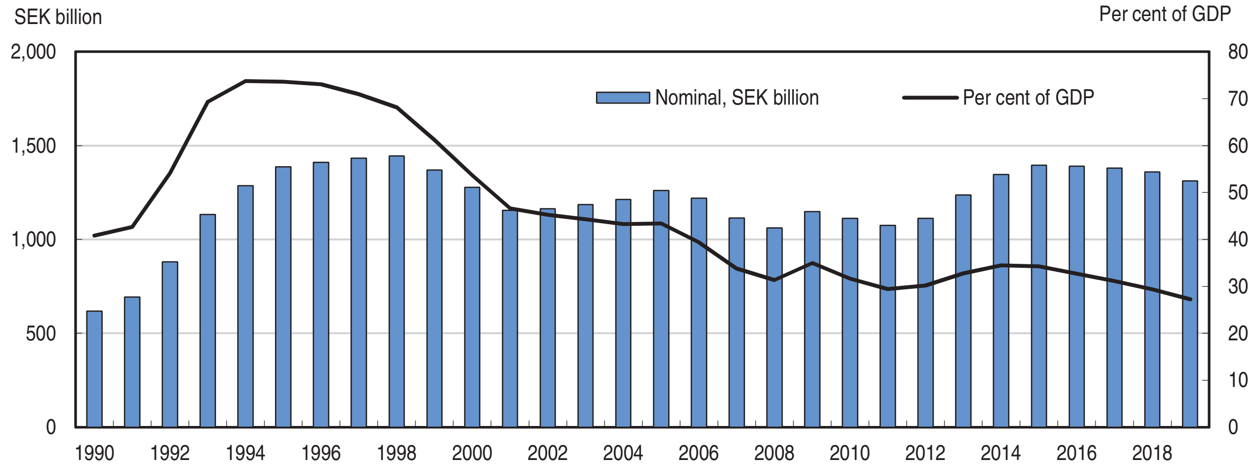


During and after the financial crisis reforms to strengthen the economy and structural reforms were easy to pass because everyone was aware of the severity. Apart from the financial framework, the pension system, the tax system, central bank independence and competition legislation were reformed and Sweden soon became a member of the European Union.

At the local level several structural reforms were launched during this period but they did not get the same attention as other reforms. One reform concerned the merger of several costly earmarked grants into a general grant together with a new equalisation system for both tax raising capacity and structural costs. This reform gave the local level an opportunity to spend more freely but also reduced income disparities across local governments. A school reform opened the opportunity for private schools to compete with public schools with public financing. This reform is now under debate because of poor school results, and the number of earmarked grants has increased. At the same time the local level had to downsize as a result of cuts in state grants which was part of the fiscal consolidation programme 1994-1998.

The fiscal consolidation programme and the fiscal policy framework have been successful in getting central government debt down from over 70% of GDP in the mid-1990s to around 35% in 2014 (Figure 11.3).

Figure 11.3. Central government debt



3. The fiscal policy framework

The fiscal policy framework consists of a number of principles. The framework is a tool to ensure that fiscal policy is transparent and sustainable in the long term. It is a prerequisite for achieving the economic objectives. Certain principles are regulated by law, while others are based on practice that has gradually developed since the financial crisis in the 1990s.

3.1. Budget framework

The budgetary framework is a key element of the fiscal policy framework. It is used to create better conditions for achieving the overall objectives of fiscal policy without jeopardising the public finances. The framework consists of several elements (Figure 11.4):

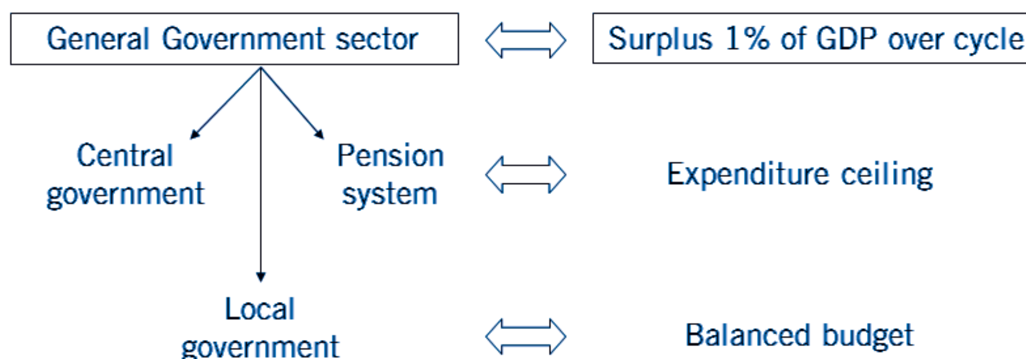
- A global surplus target for general government. Under the Budget Act, the Government must propose a net lending target for the general government sector. The Riksdag (national parliament) has established that the surplus target for net lending must amount to 1% of GDP on average over a business cycle. The current level will be maintained as long as it is thought necessary to ensure that debt develops in a sustainable way in the long term.

- A central government expenditure ceiling. Under the Budget Act, the Government is obliged to propose a ceiling for central government and old-age pension system expenditure for the next three years. The ceiling is set by the Riksdag. By determining a ceiling, the government [shows the scope for expenditure and taxes in order to meet the surplus target.

- Local government balanced budget requirement. To strengthen the budget process at the local level, a balanced budget requirement has been in place since 2000. The minimum requirement means that each municipality and county council must budget for a balanced outcome. A deficit has to be corrected within three years, although there are no sanctions. Each municipality and county council has to define the financial goals it wants to reach.

- Strict budget process. The surplus target and the expenditure ceiling set the overall scope in the budget process. The guiding principle is that expenditure increases in an area must be covered by expenditure cuts in the same area. The draft budget must include all revenues and expenditure, as well as other payments that affect the borrowing needs of the central government. This is called the completeness principle.

Figure 11.4. Budget framework



3.2. Budget procedures in the Riksdag

The Riksdag (parliament) Act (Ch. 5, Art. 12) requires that its model for drafting and deciding the central government budget shall have a clear top-down profile. In the first stage the parliament decides expenditure frameworks for the 27 expenditure areas it has laid down, as well as an estimate of budget revenues. These matters are drafted by the Finance Committee, which collects opinions from other standing committees in the course of its work. Thereafter the Finance Committee drafts a comprehensive proposal for the Riksdag to vote on. In the second stage, the standing committees consider the appropriations for the various expenditure areas. The expenditure frameworks that were decided in the first stage act as a binding restriction in stage two. This means that an increased appropriation in a particular expenditure area can now be proposed only if it is balanced by reducing another appropriation in the same area.

3.3. The surplus target

After three years of phasing in, a target for public sector net lending was introduced in 2000. The Budget Act requires the Government to propose a target for public sector net lending as well as to report to the Riksdag at least twice in a budget year how the target is fulfilled. The reports are normally included in the Spring Fiscal Policy Bill and the Budget Bill, as well as in the Government's Annual Report. The Riksdag has decided that the surplus target is to be 1% of GDP on average over a business cycle, measured in terms of general public sector net lending.[1]

The surplus target should contribute to the following objectives:

- Long-term sustainability of the public finances so that citizens, firms and financial markets have confidence in fiscal policy.
- Adequate margins for avoiding large deficits during economic downturns even when fiscal policy becomes actively counter-cyclical. As such, the surplus target contributes to a buffer that helps counteract sharply falling economic activity without risking an unsustainable increase in debt.
- A uniform distribution of resources between generations. In Sweden, as in many other countries, the proportion of elderly people in the population will become appreciably larger in the coming decades. Relatively high medium-term public savings during demographically advantageous years means that the large cohorts which will need medical care and social services in the years ahead are themselves contributing to the financing of these services.
- Economic efficiency. The surplus target promotes economic efficiency by providing better conditions for a lower tax take, and does not vary over time on account of demographic changes.

3.4. The expenditure ceiling

The expenditure ceiling was introduced in 1997. The Budget Act stipulates that the government's Budget Bill proposes an expenditure ceiling for the next three years. The ceiling is then decided by the Riksdag. If an approved expenditure ceiling is likely to be exceeded, the Act requires that, to avoid this, the government must take measures to which it is entitled, or propose necessary measures to the parliament. The expenditure ceiling's policy coverage is not regulated in law. However, the established practice is for the ceiling to apply to all expenditure areas 1–25 and 27 plus the off-budget spending for the old-age pension system. The ceiling does not include expenditure area 26 Central Government Debt Servicing. The expenditure ceiling is fixed in nominal terms, which makes evaluation transparent and simple. Moreover, a nominal ceiling gives fewer incentives for the government to try to increase inflation. It has become the practice not to amend the expenditure ceiling. The ceiling's cap on central government expenditure remains unchanged from when the ceiling for a given year is fixed until that year has ended. The ceiling has been altered on just a few occasions, due to changes in the direction of budget policy; in each case it was lowered.

There are no formal obstacles for the parliament to reassess an established ceiling. If there were, a new government's possibility of adjusting fiscal policy would be greatly restricted; neither could policy be adapted to sharply changing economic and fiscal circumstances. In addition, there may be reasons for altering an established ceiling in connection with technical budget rearrangements – e.g. technical reserves in the pension systems, which were excluded as from 2007 – so that the limiting effect of the expenditure ceiling remains the same. The central government budget process has a clear medium-term, top-down perspective. The expenditure ceiling is the overriding restriction on the budget process in terms of aggregate expenditure. Since the expenditure ceiling is set for a period of three years ahead, it underscores the need to establish priorities between different spending items. The medium-term perspective reduces the risk of temporarily high revenues (e.g. in good years) being used to finance permanently higher spending. That in turn limits the risk of fiscal policy having a destabilising (pro-cyclical) effect stemming from the expenditure side.

The expenditure ceiling is a central commitment in Swedish budget policy, promoting budget discipline and strengthening economic and fiscal policy's credibility. One of the ceiling's primary functions is to provide conditions for public finances' long-term sustainability. Moreover, the ceiling should foster a long-term view on the development of central government expenditure. In combination, the surplus target and the expenditure ceiling determine the total tax take and help to prevent a situation where insufficient control of expenditure requires an ever-increasing tax take.

4. The balanced budget requirement and the surplus target for local governments

In order to strengthen budget processes at the local level, local governments are required to balance their budgets since 2000, as required by the Local Government Act. Every municipality and county council has to budget revenue in order for it to equal at least budgeted current expenditure. Investment is exempt from the requirement, i.e. a "golden rule" applies. A local government may budget for a temporary deficit under special circumstances, e.g. if it has a strong financial position or if policy measures in one budget year entail costs but promote future cost cutting or sounder economic management. The assessment of what constitutes special circumstances is done case by case. If a local government ends a year with a deficit, the main rule is that the deviation must be corrected within three years. However there are no sanctions if that rule is breached.

The balanced budget requirement is a minimum requirement. The Local Government Act stipulates that local governments have to practice sound economic management as well. Local governments need to prepare consolidated financial accounts of their assets and liabilities, i.e. including pension commitments and reinvestment needs. As of 2005, local governments have therefore been required to set financial goals in line with sound economic management, usually amounting to a surplus equivalent to 2% of revenue from taxes and general state grants. Local governments' annual reports must include a statement of whether the balanced budget requirement and the goals for sound economic management have been fulfilled. Overall, local governments mostly reach the budget balance requirement but not the benchmark for sound economic management of 2% of revenue from taxes and general state grants.

The balanced budget requirement and the surplus target are closely connected, since sound local government finances help achieve the surplus target. The government therefore closely follows the economic development in the local government sector and includes an account in the Spring Fiscal Policy Bill and the Budget Bill. Insofar as the local government finances are dependent on the business cycle, there is a risk of pro-cyclical changes in local government spending and taxes, thereby exacerbating cyclical fluctuations. The balanced budget requirement, in itself, can reinforce this potential behaviour by local governments. In order to prevent the risk of pro-cyclical fiscal policy at the local level, the government introduced the local government regulatory reserve in 2013.

5. Other aspects of intergovernmental fiscal relations

Several institutional arrangements further shape intergovernmental fiscal relations:

- New mandates and transfers: There is a political agreement, the so-called "Local Government Financing Principle", dating from1993 and never enshrined in a law, which states that central level decisions that impose changes in costs should be adjusted via transfers between the different government sectors.
- Bailouts: As mentioned before there are no sanctions if a municipality or county council does not reach the balanced budget requirement. Most of the municipalities and county councils have reached the target. There has been no bailout since the 1980 and since 2007 there is no financial support from the central level for municipalities and county councils with financial difficulties.
- Local investment: Investment is not part of the local government balanced budget rule, while they are part of the tight central government expenditure ceiling. When it co-finances investment in infrastructure, the central government sometimes asks municipalities and county councils to contribute a higher share of investment spending since these governments have more budget flexibility.

6. External monitoring

Effective external monitoring by international as well as national bodies is important for the long-term sustainability of the public finances. International monitoring is undertaken mainly by the European Union, but also by the OECD and the IMF. National monitoring is in the hands of a number of authorities. Like other EU member states, Sweden undertakes to abide by the rules in the Stability and Growth Pact. The most central rules are the reference values for the public budget deficit (3% of GDP) and public debt (60% of GDP).

External monitoring at the national level is likewise important for an effective fiscal policy. A number of government agencies are responsible for different aspects of fiscal policy monitoring at the national level, e.g. the National Financial Management Authority, the Fiscal Policy Council, the Institute for Labour Market Policy Evaluation and the National Institute of Economic Research. The Fiscal Policy Council is specifically responsible for analysing how well the Government complies with the budgetary goals and whether the public finances are sustainable in the long term.

The Financial Stability Council is a forum in which representatives of the Government, the Swedish Financial Supervisory Authority, the Swedish National Debt Office and Sveriges Riksbank regularly meet to discuss issues of financial stability and how financial imbalances can be counteracted. If a financial crisis should arise, the Council would also function as a forum for the discussion of possible measures for handling the crisis. Meetings of the Council are chaired by the Minister for Financial Markets. Other members are the Director General of Financial Supervisory Authority, the Director General of the Swedish National Debt Office and the Governor of the Riksbank. The government and the authorities represented on the Council decide independently what measures should be taken within their respective areas of responsibility. The deliberations of the Council are published within two weeks of each meeting. The Financial Stability Council replaced the Council for Cooperation on Macroprudential Policy in 2013.

7. The budgetary policy framework might change

The support for the fiscal framework and the budgetary policy framework has been very strong since the 1990s. When the debt rate decreased before the 2008 financial crisis a discussion started with regard to the surplus target but that debate stopped when it became clear that Sweden was much better prepared for the crisis than most other countries. Over the last years the debate started again, mainly because the government found it increasingly hard to reach the surplus target. The difficulties were also highlighted by external monitors including the Fiscal Policy Council.

The new coalition government that came to power in October 2014 has announced that it might change the surplus target to a balanced budget target but that it would scrutinise the issue before passing any legislative changes. The new coalition government's first budget did not pass so that policy continues to be shaped by the budget of the previous government. To avoid further budget blockades the parties of the former government and the current minority government came to the "December agreement" which ensures that the opposition will not reject a government budget proposal. This agreement was set up to prevent a new election and runs until the elections in 2022.

Note

1. To begin with the target was 2% of GDP. When Eurostat decided that as of 2007 savings in the premium pension system could no longer be included in financial saving, the surplus target was technically adjusted, from 2 to 1% of GDP.

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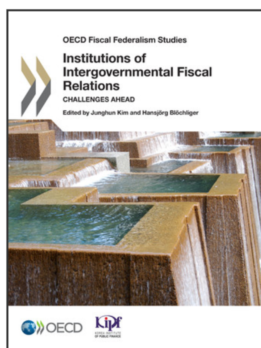

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