

Summary

A review of the surplus target, SOU 2016:67

In Sweden there is broad political consensus on the fiscal policy framework. This consensus is based on experiences from the deep economic crisis in Sweden in the early 1990s. At that time the Swedish economy was in a serious situation with very large general government deficits and rapidly increasing general government debt. In the course of the budget consolidation a surplus target was introduced for general government net lending and a multi-year expenditure ceiling for central government and pension system expenditure. Far-reaching changes were made to the central government budget process to strengthen fiscal discipline. The fiscal policy framework and the broad political consensus behind it have contributed to favourable development of Sweden's economy and general government finances. The parliamentary Surplus Target Committee now proposes minor changes to the framework.

- The surplus target for general government net lending will be retained, but the current target level of one per cent will be changed to one third of a per cent of GDP over an economic cycle. This applies from 2019 onwards.
- The framework will be supplemented by a debt anchor, i.e. a benchmark for general government consolidated gross debt (the Maastricht debt) of 35 per cent of GDP.
- There will be more stringent follow-up of the surplus target through a clearer definition of a target deviation and a plan to return to the target in the event of deviation. The Swedish Fiscal Policy Council is assigned a clearer role in the follow-up.

- The surplus target applies until further notice but is reviewed every other electoral period.¹ Broad political support for future changes in the surplus target should be sought.
- Clear principles are established for how some proposals, such as legislative proposals affecting the budget, are to be handled in the Riksdag's budget process. Work to regulate parts of the principles in law will be carried out by 2018.

The Committee assesses that these proposals further reinforce the framework. In addition, the fact that there is broad political consensus on the proposed changes indicates continued great confidence in the framework and fiscal policy.

Sweden's economy and general government finances since the introduction of the framework

General government consolidated gross debt has fallen from about 70 per cent of GDP at the end of the 1990s, to 43 per cent of GDP in 2015. If general government financial assets are included, general government net wealth was about 20 per cent of GDP in 2015, compared with a net debt of about 30 per cent of GDP less than two decades before. The central government debt and central government interest expenditure have decreased considerably and confidence in fiscal policy has been strengthened. As a result of the 2008 financial crisis the framework was tested and Sweden was one of the few countries to manage the deep economic downturn without major deficits in general government net lending while retaining the highest credit rating. Sweden is one of the only EU countries, along with Luxembourg and Estonia, that has never been subject to the excessive deficit procedure in the Stability and Growth Pact.

¹ That is, every eight years.

Experiences of fiscal policy rules in the EU and internationally

An international survey shows that the use of fiscal policy rules has increased significantly in recent decades. This applies not least in the EU. Despite this, general government debt as a percentage of GDP has increased noticeably in many countries since the end of the 1990s.

The regulatory framework for the Stability and Growth Pact has been gradually reformed and added to. Particularly after the euro crisis, extensive changes were made to augment the regulatory framework, when the crisis showed that it had functioned less well.

A comparison of the regulatory frameworks in ten countries shows that it is common for countries to change their rules over time. The extensive changes in regulatory frameworks implemented by many countries, above all in the EU, in recent years may be seen as an attempt to get to grips with the increasing indebtedness resulting from the financial crisis and the euro crisis. The Fiscal Compact regulations have also gradually formed a more integrated part of the national regulatory frameworks in the Member States covered by the Fiscal Compact.

There is relatively extensive support in international empirical research to indicate that fiscal policy rules contribute to limiting general government deficits and build-up of debt. Effects of fiscal policy rules must, however, be seen as part of an institutional context. An effective rule or combination of rules must provide scope for stabilisation policy, while at the same time having a strong link to sustainability of general government finances, which is normally measured using the level and development of debt in relation to GDP. Recent targets and rules are more complex, as they attempt to combine the sustainability motive with greater flexibility in order to manage macroeconomic shocks. Even if this is desirable, these rules are more difficult to communicate and monitor. In that context research indicates that independent institutions, such as fiscal policy councils, play an important role in that they scrutinise and comment on fiscal policy and contribute to decision-makers' credible explanation of target deviations to the public.

How does a changed surplus target relate to other parts of the framework?

An effective fiscal policy framework requires that both framework components and the framework as a whole function well. The surplus target, the expenditure ceiling and the balanced budget requirement for local governments are defined in different accounting systems and cover different parts of the general government. Despite these differences in definition, there are strong connections between the targets. These connections are not affected by a change in the surplus target level.

However, a changed surplus target level requires short-term adaptation of net lending, in particular in central government, to the new surplus target level. In the budget process the surplus target is central for estimating fiscal space for reforms. A changed surplus target affects the fiscal space in the short and medium term. Central government is responsible for meeting the surplus target, and must take into account net lending in other parts of the general government in order to do this.

A changed surplus target level requires no legislative amendment, but means that a new target level must be proposed by the Government in the Budget Bill and be adopted by the Riksdag in the so-called framework decision in the budget process.

Despite the fact that it can be argued that the old-age pension system rules make the system financially sustainable, and should therefore not be subject to the surplus target, in the opinion of the Committee the argument to retain the current order carries most weight. The fact that the surplus target covers all general government net lending contributes to simplicity and transparency and is in line with the definitions used in the EU regulatory framework.

The surplus target will be changed to a third of a per cent of GDP from 2019

Confidence in Sweden's economy and general government finances is currently high, and Sweden has a favourable general government finance position compared with most other countries. General government gross debt as a percentage of GDP has decreased

sharply compared with when the surplus target was introduced. At the same time, the cost pressure will probably increase in the next decades due to demographic changes. From accounting for the major part of general government surpluses since the introduction of the surplus target, net lending in the pension system is expected to be lower in coming years. This is a consequence of changes in the age composition of the population and not a sign that the system is underfunded. The lower net lending in the pension system increases demands on central government to save when the surplus target is unchanged. The Committee finds that this development suggests a somewhat lower surplus target in the next decade.

The report describes the consequences of five alternative target levels for net lending of between -0.5 per cent and 1 per cent of GDP. Making reasonable assumptions about interest rates and growth, if maintained, all these budget balance targets lead to the general government debt ratio moving towards a level that is sustainable in the long-term. In the opinion of the Committee it is difficult to say that one target level in the interval being discussed here is preferable to another on the grounds of long-term sustainability, fairness between generations and economic efficiency. Hence the choice of target level has become a matter of weighing up the safety margins that are judged to be necessary in a deep recession in relation to the value of the higher expenditure and/or lower taxes that a changed surplus target entails during a long transition period.

The Committee's overall assessment is that the surplus target should be changed to one third of a per cent of GDP. The principle that the general government on average should have a net lending surplus over an economic cycle thus remains in place. This target level is expected to lead to net wealth of more than 20 per cent of GDP, central government debt of about 25 per cent of GDP and general government gross debt of about 35 per cent of GDP in the medium term. Thus with this surplus target, general government gross debt will continue to fall, while net wealth will increase somewhat compared with the current level. A general government gross debt ratio of 35 per cent of GDP provides a substantial margin to the EU debt limit of 60 per cent and to the levels identified as problematical in international studies. Moreover, a

surplus target of a third of a per cent of GDP is estimated to give sufficient space to actively manage an even more long-drawn-out and deep recession without affecting the State's credit rating.

At the same time, stabilisation policy must be adjusted to the new safety margins. Lower net lending increases the importance of fiscal policy being in step with the economic cycle so that general government net lending does not fall below the EU limit in a deep recession.

The new target level should apply from 2019 onwards, i.e. from the first year of the next electoral period.

A debt anchor for the Maastricht debt of 35 per cent of GDP

The Committee takes the view that general government debt should be given a more prominent role in the framework. We propose therefore that the framework be supplemented by a debt anchor for general government consolidated gross debt, the Maastricht debt, which clarifies that the debt should continue to fall as a percentage of GDP in the medium term. The debt anchor level, i.e. the desirable level of the Maastricht debt, is set at 35 per cent of GDP, which is in line with the proposed surplus target of one third of a per cent of GDP. This agreement assumes that the surplus target is met over the economic cycle. The debt anchor strengthens the connection of the surplus target and the framework to fiscal policy sustainability.

The debt anchor is not an operational target, but a benchmark that clearly expresses a desirable level of debt. The debt anchor should be seen as a complement and not an alternative to the surplus target. The surplus target, along with the expenditure ceiling, is better suited as an operational control variable in the annual budget process. Deviations from the surplus target level in individual years is not a problem, provided that the net lending target is met over an economic cycle. Problems arise only if systematic deviations from the surplus target lead to an undesirable debt trend. It is in this context that a debt anchor plays a part, since it clearly specifies what a desirable debt level is and whether general government net lending has been sufficient to achieve it. From that

perspective, the debt anchor is part of a more stringent monitoring of the surplus target.

How should the debt anchor be followed up?

The debt anchor should be followed up annually by the Government in the Spring Fiscal Policy Bill. The Spring Fiscal Policy Bill deals with the overall guidelines for economic policy and compared with the Budget Bill has a more long-term focus. It includes assessments of the long-term sustainability of fiscal policy, which is directly linked to the debt level.

If the debt deviates by more than 5 per cent of GDP from the debt anchor, the Government must submit a special written communication to the Riksdag. The communication is to be submitted at the same time as the Spring Fiscal Policy Bill. In the communication the Government is to report the cause of the deviation from the debt anchor and how it intends to deal with it.

A number of factors may cause the debt to develop in a direction other than that predicted when the surplus target was set, even if net lending is in line with the surplus target. Therefore, in our opinion a range of ± 5 per cent of GDP is reasonable for when the Government should be obliged to submit a special communication.

The communication in connection with a deviation from the debt anchor should be dealt with by the Riksdag Committee on Finance, which can also hold a public hearing with the Minister for Finance concerning the debt situation. Apart from the requirement for a written communication to the Riksdag, the Committee's proposals do not include an automatic procedure in the event of a deviation from the debt anchor level. Instead, the idea is that deviation from the debt anchor should entail a political cost, unless there are good reasons for it. In that way a reasonable balance is achieved between increased focus on a long-term sustainable debt level and a high degree of flexibility in formulating fiscal policy.

Transparent and independent follow-up of the debt anchor is of central importance in explaining changes in the debt, as well as preventing the debt anchor from resulting in unwanted short-term measures. The Swedish Fiscal Policy Council should monitor

development of the debt in relation to the debt anchor, and analyse the factors that have impacted the debt.

The debt anchor should play a central part in the review of the surplus target that the Committee proposes should be carried out every other electoral period (i.e. every eight years). If the debt has developed in a way that is not compatible with the debt anchor, this may justify amendment of the surplus target. The review every other electoral period thus forms a link between the operational surplus target, which governs annual budget decisions, and the debt anchor.

The debt anchor applies from 2019 and is set by the Riksdag through a guideline decision

The debt anchor is set through Riksdag approval in the form of a guideline decision. Like the proposed change in the surplus target, the debt anchor is to apply from 2019 onwards.

More stringent follow-up and evaluation of the surplus target

An important condition for the credibility of the fiscal policy framework is that it is followed up transparently and clearly. External monitors of fiscal policy have repeatedly pointed out that follow-up of the surplus target has been unclear. After the Budget Process Committee's proposals, the Budget Act was amended in 2014 with a view to strengthening follow-up of the surplus target. In the framework of current provisions, the Committee proposes further steps towards improved clarity. The proposals are thus not intended to reshape but only reinforce the present follow-up system.

Definition of target deviation from a forward-looking perspective

Under the Budget Act, the Government is obliged to report how a return to the target is to be achieved if a target deviation is noted. According to the legislative comments, the analysis must *clearly* indicate a target deviation for the Government's obligation to

apply. To make the forward-looking follow-up more effective and clarify the implication of a target deviation within the meaning of the Budget Act, the Committee proposes the following definition:

A deviation from the surplus target exists if the structural balance in the current or following year, i.e. the budget year, clearly deviates from the target level.

A deviation should be interpreted symmetrically and thus apply to both positive and negative deviations from the target level. Despite uncertainty in the assessment of structural balance, the Committee considers that this measurement, calculated using generally accepted methods, is best suited to assessing whether fiscal policy is compatible with the surplus target.

The fact that the target deviation is defined on the basis of structural balance in the current year and the budget year does not mean that less importance is attached to the medium term perspective in the budget process. The restriction to these two years when assessing target deviation makes it clear, however, that in practice it is in the decision on the budget that the Government and Riksdag determine whether the surplus target is met.

By defining target deviation on the basis of structural balance, greater agreement is achieved with the follow-up of the medium term budget objective (MTO) at EU level.

The implication of returning to the target is made clear

Under the Budget Act, the Government is obliged to report how net lending is to return to the target in the event of a target deviation. To increase the credibility and focus of such an adjustment plan it is made clear that it must set a time limit and normally start in the budget year, i.e. impact fiscal policy in the Budget Bill for the following year. If the Government considers that a deviation cannot be corrected in the following budget year, the Government's plan must contain a clear political commitment for structural balance in the year or years after the budget year. An adjustment plan should normally be formulated so that the target level for net lending is met when the economy is in balance. When the economy is booming, structural balance should be above the target level in the same way as it should lie below the target level in

a downturn. As a rule of thumb, in a normal economic situation a target deviation should decrease at the same rate as is normal when there are no active political decisions, but more in good times and less in bad times.

If, as a result of systematic deviations from the surplus target, the debt was to fall outside the debt anchor's tolerance margins it is reasonable that this will be significant in estimating the pace of return when there is a deviation from the surplus target.

A fiscal policy council focusing on the fiscal policy framework

It should be explicitly stated in its instructions that the Swedish Fiscal Policy Council's remit includes assessing whether a deviation from the surplus target exists. The Council is also to assess whether any deviation is justified, and the pace at which a return to the target should be implemented. The assessment of target achievement is to be reported in the Swedish Fiscal Policy Council's annual report.

The Swedish Fiscal Policy Council should focus its analysis more clearly than it does today on how fiscal policy relates to the fiscal policy framework. The Council constitutes a central part of the more stringent follow-up of the surplus target, and the intention is to shift the emphasis of the Council's work, without this entailing a restriction on its mandate in relation to current tasks. The Riksdag's annual hearing in response to the Swedish Fiscal Policy Council's report should accordingly be focused to a greater extent on the fiscal policy rules and framework.

A backward-looking eight-year average of actual net lending to evaluate surplus target achievement

To retrospectively evaluate achievement of the surplus target and discover systematic deviations, a backward-looking average of actual net lending is to be used. Accumulated deviations in net lending that lead to undesirable debt levels may justify adjustment of the target level for net lending at the next surplus target review. The debt anchor proposed by the Committee will clarify the level of debt that is being sought.

The retrospective indicator will be reported in the *Central Government Annual Report* and thus be subject to the annual audit by the Swedish National Audit Office.

Further proposals to strengthen the Swedish Fiscal Policy Council

An analysis of the Swedish Fiscal Policy Council in an international perspective shows that the Council fulfils most of the recommendations for independence and impartiality presented by international organisations. On some points the Committee proposes changes for the purpose of further strengthening the Council in its role of following up and evaluating fiscal policy and fiscal policy rules.

For the purpose of guaranteeing the breadth and competence of the Council, the Government should appoint a nominating committee for election of Council members. To simultaneously strengthen the Council's independence in relation to the Government, members of the Riksdag Committee on Finance should be included in this nominating committee.

The Council will be instructed to make regular evaluations of the Government's forecasts of macroeconomic development, general government net lending, and the cost accounting for reform proposals submitted to the Riksdag. An external evaluation of the Swedish Fiscal Policy Council's activities should be made approximately every fifth year and be made public.

The Government is to submit an updated fiscal policy framework communication to the Riksdag

The Government is to submit an updated fiscal policy framework communication to the Riksdag in which changes to the framework and follow-up are presented. The Fiscal Policy Framework Communication (Govt. Communication 2010/11:79) contains current follow-up principles and needs to be updated when changes are made to retain and strengthen its status as the assessment standard against which the Riksdag, the Swedish Fiscal Policy Council, the Swedish National Audit Office, the National Institute of Economic Research and other monitors follow up fiscal policy.

The surplus target will be reviewed every other electoral period

The Committee considers that an approved surplus target should apply until further notice but be reviewed every other electoral period (i.e. every eight years). A surplus target for general government net lending has no intrinsic value but is intended to achieve more overall objectives for fiscal policy, objectives that are closely connected to debt and wealth levels. New information on demographics, debt levels or how net lending in different parts of the public sector are developing, may change the conditions compared with when the current surplus target level was established.

We consider that a review of the surplus target should be made at the end of every other electoral period to enable any revised target to enter into force in the first year after an ordinary Riksdag election. To prevent uncertainty from arising concerning the target level in force when the time for review approaches, it should be established that an approved surplus target applies until further notice. It is important to emphasise that regular review of the surplus target does not mean that the target level will necessarily be changed every time, just that it will be analysed again in a predictable way.

It is central for safeguarding the stability and credibility of the framework that a review has the broad support of the Riksdag parties.

If the debt at the time of a future review of the surplus target has not developed in line with the debt anchor, this may justify changing the surplus target. In that sense the debt anchor means that the debt level sought will be clear, given the approved surplus target. But as with the surplus target, the assessment of the desirable level of the debt may be changed for reasons such as demographic trends or a changed need for safety margins. Consequently, the level of the debt anchor should also be evaluated at the review every other electoral period.

Treatment of some proposals with an impact on the budget in the Riksdag's budget process

Sweden has a long tradition of broad consensus as regards the fundamental structure and function of the political system, including the significant rules that govern the budget process. It is important that the Budget Bill is drafted and approved as a whole in order to maintain the purpose of the framework decision process.

To create increased clarity on how some proposals with an impact on the budget are to be treated in the Riksdag's budget process, the Committee supports the principles presented by the Budget Process Committee (Swedish Government Official Reports SOU 2013:73), but which did not receive broad political agreement. The principles concern how to deal with the following in the Riksdag's budget process: (1) legislation impacting the budget, (2) budget-related announcements to the Government, and (3) proposals put forward in the Riksdag outside the ordinary budget process and that have a clear impact on the central government budget. We also propose that the Government starts working on legislation to regulate (1) above, and to review the extent to which (2) and (3) can be regulated in that way. This work is to be completed by 2018.

The report's conclusions were supported by 7 out of 8 Riksdag parties.²

² The Social Democratic Party, the Moderate Party, the Green Party, the Centre Party, the Left Party, the Liberal Party and the Christian Democrats.