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Jonung, Lars

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LUND UNIVERSITY

PO Box 117
221 00 Lund
+46 46-222 00 00

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Department of Economics
School of Economics and Management

Reforming the Fiscal Framework. The Case of Sweden 1973-2013

Lars Jonung

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Reforming the fiscal framework

The case of Sweden 1973-2013

Lars Jonung

Department of Economics, Knut Wicksell Centre for Financial Studies, Lund University,
Lund.
Lars.Jonung@nek.lu.se

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Forthcoming in: *Reform Capacity and Macroeconomic Performance in the Nordic Countries*, Oxford University Press, edited by Torben M. Andersen, University of Aarhus, Michael Bergman, University of Copenhagen, and Svend E. Hougaard Jensen, Copenhagen Business School.

Abstract: This paper explores the evolution of Swedish fiscal policy from one extreme approach to another one in less than four decades. After the demise of the Bretton Woods-system in the early 1970s, Swedish fiscal policy was based on a Keynesian approach with the goal to stabilize the business cycle and maintain full employment using a large set of instruments in a discretionary manner. In the wake of the deep financial crisis in the early 1990s, this policy paradigm was eventually replaced by a rule-bound scheme. A fiscal framework was set-up as an instrument to rein in public finances. The present goal of fiscal policy is to maintain sustainable public finances while avoiding discretionary measures.

The fundamental changes in the past 40 years in the fiscal policy regime – the goals, the instruments and the institutional framework for fiscal policy-making – is studied as the outcome of a learning process where the economic crises hitting the Swedish economy forced policy-makers and economists to rethink and redesign the use of fiscal policy. The process of policy learning is a continuous one. New changes in the fiscal regime will follow in the future.

By now, Swedish public finances are among the strongest in Europe. Sweden may serve as a model as it has carried out a successful fiscal consolidation since the mid-1990s while simultaneously developing a comprehensive fiscal framework and displaying an impressive macroeconomic record. A set of policy lessons are distilled.

Key words: Fiscal rules, fiscal policy council, fiscal policy, policy learning, Sweden.

JEL codes: E52, E62, E63, E65, F44, H62 and O52.

1. Introduction¹

Swedish public finances stand out among the strongest in Europe in the mid-2010s. How do we explain this outcome? One reason for the prevailing fiscal caution is found in the fiscal policy framework that was put in place over the past 20 years, since 2007 also including a fiscal policy council. Today, Swedish fiscal policy is rule-based, reigned in by a number of restrictions. This state of affairs is in sharp contrast with the fiscal policy of the 1970s and 1980s founded on a Keynesian approach allowing policy-makers a wide freedom for fiscal actions. In short, Swedish fiscal policy has moved from one extreme of fiscal laxness to the other of fiscal prudence in the past 40 years.

This transformation is analyzed here as the outcome of a long and still on-going learning process. In short, major economic crises have induced policy-makers as well as university economists to rethink the proper conduct of fiscal policy. As a result of this learning process, the fiscal policy regime which covers the goals, the instruments and the institutional framework for fiscal policy-making has been transformed.

This account is organized in the following way. First, as a background for the narrative, the macroeconomic record of Sweden since the 1970s is described. After this introduction, two major sections follow. The first one focuses on the stabilization policies of the 1970s and 1980s that culminated in the deep financial crisis of the early 1990s. This crisis became the catalyst for fundamental change in fiscal policy. The second section describes the fiscal framework that emerged in Sweden after the crisis of 1992-93 and presents the lessons that can be learned from it so far. The focus is set here on the Fiscal Policy Council as it has attracted considerable interest.

2. The macroeconomic record

Economic growth in Sweden was weak in the 1970s and 1980s but recovered after the crisis in 1992-93 (Chart 1). The financial crisis during these years caused a sharp drop in real income. The crisis forced the *Riksbank* to abandon the fixed exchange rate of the *krona* in

¹ Johanna Modigsson has skillfully prepared the tables and charts. Fredrik N.G. Andersson, Michael Bergman, Henrik Braconier, Niklas Frank, Oskar Grevesmühl, Per Molander, Tomas Nordström, Joakim Sonnegård and Hans Tson Söderström have provided constructive comments. The usual disclaimer holds.

November 1992, setting off a sharp and long-lasting depreciation. The floating of the currency contributed to a long recovery, lasting up till the Great Recession. The depreciation of the *krona* had a significant effect on exports. They rose rapidly as measured by the share of exports to GDP, from around 27 percent of GDP in 1992 to a level around 50 percent by 2008 (Chart 2). The global financial crisis 2008-10 caused a minor decline in the ratio. The improvement in economic performance since the crisis of the 1990s has been a boon to the Swedish economy during the recent global depression.²

The turn-around of the Swedish economy after the crisis of 1992 is also evident in the behavior of inflation and interest rates. The rate of inflation was high and volatile in the 1970s and 1980s (Chart 3). Since the mid-1990s it has been low and more stable. The same holds for the nominal rate of interest (Chart 4) displaying the long-term interest rate on government bonds.

The economic growth performance had a major impact on fiscal policy as summarized in Chart 5-8. Chart 5 shows government gross debt to GDP for the period 1970-2013. In the early 1970s, government debt was roughly stable. The two oil price shocks (OPEC I in 1973-74 and OPEC II in 1979-81) elicited an expansionary fiscal policy response with rising budget deficits (government net lending) and thus with rising gross debt (Chart 6). In the mid-1980s, the debt ratio started to decline. The financial crisis of the early 1990s set off a sharp and substantial rise in the ratio, which peaked at around 80 percent in the mid-1990s. Since then the ratio has been falling gradually.

The recent global financial crisis starting in 2008, the Great Recession, is not reflected in any major rise in the debt ratio for Sweden although this crisis caused a sharper fall in economic growth than the crisis of the early 1990s. This is also seen from Chart 7 displaying general government net lending as a percent of GDP for EU member states in 2013 and from Chart 8 demonstrating general government gross debt as a percent of GDP for EU member states in 2013. Chart 7 and 8 reveal that a large number of countries in Europe are experiencing major problems with high deficits and debts. There are a few exceptions. As noted, Sweden is one of them, actually displaying strong public finances as reflected in a falling debt ratio since the mid-1990s (Chart 4).

² See OECD (2012, p.9). Many factors contributed to rapid economic growth after the crisis of the 1990s, including a number of major supply-side reforms. For an account see Jonung, Kiander and Vartia (2009).

3. Changing the paradigm for stabilization policy 1970-2013

3.1. An overview

In the early 1970s, Swedish stabilisation policy had a number of goals: a fixed exchange rate for the *krona*, full employment, low inflation, high growth and “low” interest rates. The box of policy tools included a number of selective instruments. The scope of policy action was determined by the fixed exchange rate for the *krona* and implicit prohibitions against public borrowing from outside Sweden. Capital controls shielded the Swedish financial system from the rest of world. Due to these external controls, domestic financial markets were extensively controlled by the *Riksbank*, where the under-secretary of the Ministry of Finance was commonly the chairman of the board of the *Riksbank*, signifying the power of the Ministry of Finance over the framing of monetary policy. The ruling philosophy of stabilisation policy, “the policy paradigm”, was based on Keynesian theory, which emerged as the principal macro-theory after World War II, reinforced by ideas from the Stockholm School of Economics.

Swedish macroeconomic performance in the 1970s, 1980s and early 1990s turned eventually into a source of disappointment. As noted above, economic growth during this period was lacking. These decades were also marked by large budget deficits, rising government debt and high and volatile inflation and recurrent devaluations of the *krona*. During the crisis of the early 1990s, unemployment reached a high and persistent level.

Eventually, a new view regarding the proper strategy for fiscal and monetary policy emerged, replacing the view that prevailed prior to the crisis of the 1990s. New goals, new instruments and a new institutional framework were established after the crisis.

The goals for stabilisation policy changed as well as the ranking among the goals. The fixed exchange rate for the *krona* was replaced by a floating exchange rate in November 1992. Inflation targeting replaced the fixed rate. The monetary policy goal was set as a target of 2 percent inflation per annum within a band of plus/minus one percentage point from 1995. The target band was abandoned in 2010 while the goal of 2 percent remained. The primary goal of fiscal policy after the crisis of the 1990s was fiscal consolidation and sustainable public finances. A surplus target of one percent of GDP holds for the general government sector over the course of the economic cycle since 2000.

The old set of stabilisation instruments has been replaced by a new one. Selective instruments like the system of investment funds, once receiving international praise, as well as various regulations of the credit and capital market have been scrapped.

The institutional framework for stabilisation policy has changed significantly. The *Riksbank* has been given a more independent role from the government. Fiscal policy is managed with the help of new budget legislation as reflected in a new fiscal framework, including a fiscal policy council.

How should this process of changes in the goals, instruments and institutions for fiscal and monetary policy be explained? The theoretical literature regarding economic policy gives little guidance as traditional theories are based on the analysis of stabilisation policy behaviour within *given* structures and with *given* policy preferences.

A striking feature of Swedish stabilisation policy since the beginning of the 1970s is the close relationship between the policy of the past and of the present. From this perspective, changes in policy, often classified as “reforms”, represents responses to earlier policies. In short, policy-makers are involved in policy learning.

Policy learning may be defined in the following manner. Those responsible for stabilisation policy learn as they consciously adapt the combination of goals and instruments to new circumstances taking into consideration earlier experiences and new information. From this perspective, policy changes or reforms emerge as a result of learning or, to be more precise, of relearning, that is by revising old notions regarding the proper choice of suitable goals, instruments, strategies and institutions for stabilisation policy.³

For several reasons, the Swedish experience of the past 40 years stand out as unique, making it a suitable subject for studying policy learning. First, participants in the stabilisation policy process have documented their experiences and views diligently. Second, the structure of the political system has allowed Swedish politicians to test different stabilisation strategies more directly than politicians in other countries have been able to do, thereby obtaining rapidly information about policy outcomes. The scope for policy action has been large as well. During the years 1970-95, no formal restrictions on fiscal policy in the form of limits for the budget deficit or the central government debt existed. The *Riksbank* was subject to close political control by the government. This institutional framework is part of the reason why

³ This approach is developed in Jonung (1999).

stabilisation policy activism in Sweden became so extensive prior to the 1990s compared to the case of most other OECD-countries.

Third, the leading “activist” stabilisation policy approach contributed to Sweden becoming something of a test site for stabilisation policy experiments during the last quarter of the 20th century. This laboratory produced a rich harvest of experiments, which form the central part in the learning process.

3.2. The learning process 1970-2013

The different elements of the learning process during the years 1970-2013 is summarised in Table 1. It is based on dividing the sequences of changes in the framing of stabilisation policy into four stages. The first stage consists of a macroeconomic disturbance, see column (1), which, with a lag, triggers a policy reaction in the form of fiscal and monetary measures aimed at counteracting the disturbance, see column (2). In this second stage, the policy reaction is extracted from the policy lesson in the period/crisis immediately preceding stage 2. Eventually, the policy response affects the economy in stage 3, see column (3). In due time, and the time lag can be considerable here, economists and politicians reach conclusions when they evaluate the outcome of the policies conducted.

Here they learn new lessons when they revise their opinions about the proper future policy reaction. This learning determines the policy reaction when the next macroeconomic disturbance occurs as shown below covering five episodes – each of them defined by an aggregate shock to the Swedish economy during the period 1970-2013.

Episode 1. 1969-72. An outflow of capital from Sweden induced the government to carry out a tight fiscal and monetary policy to improve the current account. This policy reaction was based on lessons from the Bretton Woods system. Within this institutional framework, a currency outflow required tightening of the domestic economy.

The policy of restraint gave rise to harsh criticism from the opposition parties and from economists. The opposition based its arguments on a Keynesian approach: fiscal policy should be more expansionary in order to counteract the rise in unemployment registered in 1971-72. The criticism contributed to a change towards expansionary policies from the end of 1972.

Episode 2. 1973-74. The next major disturbance was OPEC I, the first oil price shock in 1973-74. The lesson from the 1969-72 episode of tight monetary and fiscal policies decided the policy reaction by the government. It was reluctant to counteract the OPEC I crisis with a policy of restraint. Instead, the Swedish policy reaction was based on the idea that the expected international economic downturn after OPEC I could be avoided by expansionary fiscal policy. This “policy of bridging-over” was likely the most pronounced Keynesian policy experiment among OECD countries in the 1970s.

The attempt of bridging-over eventually failed as it resulted in a growing budget deficit and a deficit in the current account in 1975-76. The acute crisis was brought to an end by two “defensive” devaluations in 1977.

Episode 3. 1979-80. The next macroeconomic disturbance had its origins in the second oil price shock (OPEC II) of 1979-80. The lessons from “the policy of bridging-over” triggered a policy reaction different from the response to the OPEC I crisis. Fiscal policy was now tightened. Devaluations were adopted at an earlier stage than during the OPEC I crisis. In 1981, the *krona* was devalued by 10 percent. The non-socialist parties in government went to the polls with a program of fiscal restraint in the autumn of 1982, as opposed to the 1976 election in which their program focused on expansion.

The social democratic opposition campaigned against the “belt-tightening”. After winning the 1982 election, the new social democratic government carried out a devaluation of 16 percent in October 1982 as its first measure. This “aggressive” devaluation summarised the lessons from the OPEC I crisis. The devaluations in 1981 and 1982 brought about rapidly increasing prices, wages and profits, which became a major problem during the years to follow.

Episode 4. 1990-1992. The experience of the devaluations of 1981 and 1982 contributed to a new view. Economists recommended a fixed exchange-rate policy that would not accommodate negative disturbances through exchange-rate adjustments. Sweden should convert to a low inflation strategy by a credible commitment to a fixed exchange rate for the *krona*, in this way importing the lower rate of inflation assumed to prevail among its main trading partners, in particular in Germany.

The course of events leading to the next deep macroeconomic crisis can be traced back to November 1985, shortly after the general election that fall, when the decision was taken by the *Riksbank* to deregulate the domestic credit market. During the following years, the supply

and demand of credit increased swiftly. The real rate of interest adjusted for taxes became negative for many borrowers. The prices of capital assets, such as shares and real estate, rose drastically. Prices and wages increased markedly, particularly in 1988-89. Registered unemployment stood at two percent during these years, clearly indicating that the economy was overheated.

Around 1991, the boom turned into bust and deep recession, the most severe in the post-war era. Unemployment increased. The budget deficit accelerated. In real terms, national income declined three years in a row – a unique pattern without parallel in Sweden during the 20th century. The acute crisis was resolved when the *Riksbank* was forced to abandon its defence of the fixed exchange rate of the *krona* in November 1992, allowing the *krona* to float.

The 1990s crisis contributed to a revision of the policy lessons gained in the 1980s. A new and fundamental lesson regarding monetary policy after the failed defence of the *krona* was that a fixed exchange rate for the *krona* is difficult to uphold in a world of deregulated and open financial markets. The old goal of monetary policy, the fixed exchange rate for the *krona*, was replaced by a new goal in January 1993: a low inflation norm or a price stability norm.

Fiscal policy was focused on fiscal consolidation after the acute crisis of the 1990s and the large budget deficits following in its wake. Shortly after the crisis, the foundations of a new fiscal framework were established. Balancing the budget became the primary target for fiscal policy against the background of a rapidly increasing central government debt.

Episode 5. 2008-2010. The global crisis that started in 2008 following the Lehman collapse in the United States had a major impact on the Swedish economy via international trade. Swedish economic growth fell sharply in 2009, amounting to a decline by five percent in one year, the sharpest annual fall in the post war period. The crisis was met primarily by an expansionary monetary policy while fiscal policy was largely unchanged.

Policy-makers and economists alike blamed much of the crisis on a failure of regulating the financial system properly. The lesson that has emerged so far suggests that the regulatory framework should be strengthened through the use of new macro-prudential instruments. The process of lesson-learning is still going on.

Summing up. The different episodes described in Table 1 amounts to a series of interconnected experiments where the outcomes and the interpretations of the various

experiments form the core of the learning process. Each episode is an experiment that results in new lessons. The feedback loops between the present policy and the policy of the past are strong. Stabilisation policy is characterised by “path dependency”, although the policy-makers probably considered their decision-making situation to be unique during each separate crisis.

Table 1 brings out two central features. First, the design of stabilisation policy is “event-driven”, that is driven by major macroeconomic disturbances. Second, policy-learning is a continuous process, as indicated in the lowermost part of Table 1. When the next crisis hits the Swedish economy in the future, the policy reaction will be determined by the lessons gained from the present global financial crisis.

4. The new fiscal framework after the crisis of 1992

Eventually, primarily as a response to the crisis of the early 1990s, a fiscal framework was constructed in a political and administrative process covering several years. Actually, this process still continues.⁴ A major initial step was a report published in 1992 by ESO, a small research council formally under the Ministry of Finance but independent in its choice of topics to be studied. This study, put together by Per Molander, at that time serving as head of the secretariat of ESO, recommended a top-down approach for the government budget in the Parliament, a stronger position for the Prime Minister’s office and the Ministry of Finance in the internal budgetary process and a full coverage for the financing of government expenditures. The ESO-report, inspired by a study by Jürgen von Hagen (1992) of the budgeting procedures in 12 member countries in the European Community, demonstrated that the Swedish budgetary process was a weak one in an EC perspective, ranked at the bottom between that of Greece and Italy.⁵

The ESO report contributed to a parliamentary reform in 1994 encompassing a top-down approach where the Parliament first decided the total volume of expenditures and then the distribution of expenditures across 27 specific expenditure areas. The calendar year became

⁴ The emergence of the Swedish fiscal framework is covered in several contributions. See Calmfors (2013), Calmfors and Wren-Lewis (2011), Molander (1999) and Molander and Holmquist (2013).

⁵ The report is von Hagen (1992). It was later extended in von Hagen and Harden (1994).

the basis for the budget. From January 1997 an extended fiscal framework was put in place, including a central government *expenditure ceiling* designed to cover expenditures three years ahead decided by the parliament, the abolishment of open-ended appropriations and monthly auditing of government expenditures relative to budget.

In 1998, a *surplus target* for general government net lending was introduced, to be implemented from 2000. Public finances were now required to show a surplus of 1 percent over the course of a business cycle for the whole public sector (Chart 9). The surplus target was commonly viewed as a buffer for economic fluctuations and demographic changes. In 1999 a *balanced budget requirement for local governments* was made into law to be implemented from 2000.

The next building block of the fiscal framework was put in place in 2007 when a *fiscal policy council* was established by the center-right government that came to power after the election in the fall of 2006. The process of developing the fiscal framework has continued. In 2010, the budget act was amended and the use of the expenditure ceiling and the target for general government lending was made mandatory. The build-up of the fiscal framework 1995-2011 is summarized in Table 2.⁶

By now a full-fledged fiscal framework has been established with the basic aim of fostering a sustainable fiscal policy in the long run. The framework is made up of a few fundamental principles or rules for fiscal policy. Some are governed by law, as displayed in Table 2, while others follow a practice that has emerged over the past 20 years.

The budgetary framework, as set out in the Budget Act, is the core of the legal basis of the fiscal framework. According to this act, the Government is obliged to propose targets for general government lending to the *Riksdag*. The surplus target is presently defined as an average of 1 percent of GDP over the business cycle. Under the Budget Act, the Government

⁶ Important changes in the parliamentary budget procedure to strengthen the fiscal framework were also made after the crisis of the 1990s. The Finance Committee of the *Riksdag* was given a more powerful role. A strict top-down decision model was introduced where the Finance Committee sets binding limits for all expenditure areas that the special committees of the *Riksdag* cannot exceed, and where any expenditure increase must be financed within the same area and by the same committee.

must propose an expenditure ceiling for the third year ahead in the Budget Bill presented in the fall to the *Riksdag*.

The expenditure ceiling has served as a fundamental restriction on the budgetary process. It sets a cap in nominal terms for government expenditures, reducing them measured as a share of GDP (Chart 10). So far, the expenditure ceiling has not been revised upwards except for minor technical adjustments. The ceiling has not prevented government expenditure to grow in nominal terms over time (Chart 10). Under this ceiling or cap, expenditures are allocated across different spending areas. The main idea is that proposals by members of the *Riksdag* for expenditure increases in one area should be covered by proposals for expenditure reductions on other activities within the same area.

The balanced budget requirement covers the local government sector which makes up a large part of the Swedish government sector. In 2011, local government expenditure constituted about half of total government spending. They represented slightly more than 20 percent of GDP. The balanced budget rule stipulates that each municipality and county council must plan for a balanced budget.

The Government has also presented a number of principles or guidelines – not put into law – concerning the design and use of stabilization policies. The most important task of fiscal policy is to maintain confidence in the long-term sustainability of public finances. The task for monetary policy is to stabilize both the rate of inflation at a low level and aggregate demand in the economy under normal demand shocks. Thus, the use of active (discretionary) fiscal measures is ruled out during a normal business cycle. Instead, the main countercyclical effect of fiscal policy is provided via the workings of automatic stabilizers. However, very large demand and supply shocks may allow for an active fiscal policy response to limit the rise in unemployment. Financial crises may also require special measures to maintain financial stability.

5. The Fiscal Policy Council

By now the Fiscal Policy Council is probably the component in the Swedish fiscal policy framework that has attracted most interest in public debate as its annual report has turned into a major media event, commented on by the government and the opposition. The Council so far represents a major step in a reform process that should properly be classified as a learning process – in short learning from the fiscal crises of the past.

5.1 The establishment of the Council⁷

The roots of the Council can be traced back to a government commission reporting in 2002 on the role of fiscal policy in the event of Sweden becoming a member of the euro area, thus losing the use of an independent monetary policy in the framing of stabilization policies. Here the idea of a Swedish Fiscal Policy Council was discussed for the first time.⁸ No legislative step towards a council was taken in response to the report of the government commission, however.

The idea of a fiscal council attracted the liberal-conservative government that came to power in the election of 2006. At the initiative of the Minister of Finance, a fiscal policy council was established one year later. The initiative first encountered negative reactions from the three parties in opposition: the Social Democrats, the Left Party and the Green Party. The Left Party expected the fiscal council to serve as “another body providing false scientific clothing for the government’s right-wing policy”.⁹

A fiscal council was a novelty for Sweden although similar institutions or authorities have actually existed in countries like the Netherlands and the US for a considerable time. Various forms of fiscal policy councils are now established in about 16 countries. The number is expected to grow in the near future as the EU, IMF and OECD are recommending the introduction of fiscal policy councils or independent fiscal authorities.

The Swedish Council is set up as an agency under the Government, directly under the Ministry of Finance. Its budget is determined by the Ministry of Finance and thus by the Government. Presently, the Council has a small secretariat made up of five persons. The annual budget is about 9 million SEK, approximately 1 million euro. The Council is thus a very small body by international comparison.¹⁰ The Council, however, has the option of asking outside experts to prepare reports on issues of interest. These usually serve as inputs

⁷ Accounts of the Swedish fiscal policy council and its impact are found in i. a. Calmfors and Wren-Lewis (2011) and Flodén (2013). The role of fiscal policy and the fiscal framework during the recent crisis is discussed by i. a. Bergman (2011) and Hassler (2010). See also the report by the Swedish Fiscal Policy Council (2012).

⁸ Wyplosz (2002) prepared a contribution on fiscal policy councils to the commission. His piece inspired the commission in its recommendations.

⁹ Calmfors and Wren-Lewis (2011, p. 682).

¹⁰ See the comparison of the tasks of various fiscal councils in Table 2 in Calmfors and Wren-Lewis (2011).

into the annual report of the Council. The Council also arranges a yearly conference where the reports prepared by outside experts commissioned by the Council are presented.

The Council has six members with fixed terms of appointment – it ranges between a maximum of three years for the ordinary members to six years for the chairman. The members hold positions at universities and/or have made careers as policy-makers or as high level civil servants. They serve as members on a part-time (10 percent) basis, as a supplementary activity to their ordinary jobs or positions. The Council is in principle a self-perpetuating body. It recruits itself in the sense that it proposes to the Government replacements for members who are leaving.

5.2 The remit of the Council

The tasks of the Council are defined in a remit framed by the Government. The first instruction was presented in 2007. A new instruction was given in April 2011. It is short, roughly one page long, stating that the main task of the Council is “to monitor and evaluate the extent to which the fiscal and economic policy objectives proposed by the Government and decided by the *Riksdag* are being achieved and thus to contribute to more transparency and clarity about the aims and effectiveness of economic policy”.¹¹

Starting from the Spring Fiscal Policy Bill presented in April and the Budget Bill announced in September, the Council assesses whether the fiscal policy of the Government is consistent with:

1. long-term sustainable public finances and
2. budgetary targets, particularly the surplus target and the expenditure ceiling.

More specifically, the Council has to:

1. assess whether the fiscal policy stance is consistent with cyclical developments in the economy,
2. gauge whether fiscal policy is in line with long-term sustainable growth and leads to long-term sustainable high employment,

¹¹ Swedish Code of Statutes SFS 2011:446. This section is a rough translation of this code.

3. examine the clarity of bills concerning economic policies, particularly with respect to the arguments for policy measures,
4. analyze the effects of fiscal policy on the distribution of welfare in the short and the long run.

The Council may assess the quality of the forecasts made by the Government and the models on which the forecasts are based. Finally, the Council should foster public debate on economic policy.

This remit represents a broad mandate, in particular the request to examine the consequences of economic policies on the distribution of income and wealth. This was a new task given by the instruction of 2011 as part of a compromise between the Government and the opposition.

The starting point of the remit is the fiscal framework. It requires the Council to examine to what extent the actual measures of the Government are consistent with the fiscal framework. This task facilitates the Council's work by giving it a benchmark to start its evaluation of the economic policies of the Government. The Council is then free to express its opinions concerning any issues it deems of importance for fiscal sustainability, as well as issues it finds to be neglected or ignored by the Government.

The Council is set up at arms-length from the Government. It has no informal or confidential contacts with the Government. It is not involved in policy-making consultations with the Government; it does not provide the Ministry of Finance with any judgments, forecasts or recommendations except what is made public in the annual report of the Council and the reports prepared for the Council by outside experts. All its communication with the Government thus takes place in the public sphere. It has the authority to ask the Ministry of Finance for information about the work underlying the proposals of the Government. So far, the books of the Ministry of Finance have been open to the Council when it has made requests.

5.3 The Council's reports 2007-13

Gradually, the Council has by itself established a reputation of being independent. This is probably a major reason why in 2011 a new instruction for the Council was supported by the Social Democrats, the Left and the Greens, at this time in opposition. It is fair to say that the Council is now well entrenched in the Swedish political system in the sense that it has presently the backing of seven out of eight parties in the Parliament.

The main tool of the Council for communicating its message is the annual report. The first report of the Swedish Council was published in 2008, followed by annual reports since then. It is published in mid-May. A few weeks later, the report is presented by a member of the Council, usually the chairman, at a hearing before the Committee on Finance of the *Riksdag* where the Minister of Finance responds as well. The report serves as an input for the Committee's evaluation of the economic policies of the Government. The Government replies in the Budget Bill to the report of the Council, usually in September the same year.

The six annual reports produced in 2007-2013 have focused on a number of issues. One theme is a recurrent plea for increased clarity concerning the surplus target. The Council has asked for explanations of the fundamental objectives of the surplus target as the Government has given various explanations over time. The Council has also made requests regarding how the Government monitors the compliance with the target.

The Council has criticized attempts of circumventing the expenditure ceiling, when actual expenditures have approached the cap set by the expenditure ceiling. It has scrutinized the Government's fiscal sustainability calculations. It requested temporary discretionary fiscal stimulus in the recession of 2009-10. It has questioned the evaluations of the Government's labor market reforms and the economic reporting of the Government. So far, the fiscal policy pursued in recent years has complied with the fiscal framework. However, there is a considerable risk that this will not be the case in coming years. In the report from May 2013, the Council expressed strong doubts about the Government's commitment to the surplus target.¹²

The Council has stressed in several reports that rapidly expanding credit and rising property prices imply macro-financial risks for the Swedish economy. The Council has recommended the Government to decide how macro-prudential regulation and supervision should be strengthened to reduce the risk of future financial crises.

Many of the issues brought up by the reports of the Council have attracted the interest of the media. For this reason several issues remain in public debate. The annual reports are cited and referred to long after their initial publication.

¹² See the Swedish Fiscal Policy Council (2013).

5.4 The independence of the Council

Representatives of the Council commonly describe the Council as a watch-dog that barks when fiscal sustainability is threatened by the economic policies of the Government. In other words, the Council tries to serve as an early warning system for threats against fiscal stability. The proper question to ask is then: How well can it fulfill this function when it is financed by the Ministry of Finance?

It has been proposed that the Council should be organized under the Parliament instead, reporting directly to the Parliament, in order to minimize any direct pressure by the Government. So far, the general view is that the Council has managed to remain independent and thus credible in the eyes of the media and the public. This independence is based on various mechanisms, formal as well as informal; some of which may not work or may not be as strong in other countries.

Firstly, the Council is made up of members who are independent of the Government, as they are recruited from academia or from end-of-career positions. They are taken from outside of the political system.

Secondly, the Council recruits itself by openly proposing new members to the Government. The Government has so far accepted and supported all proposals.

Thirdly, an important pillar of the independence of the Council is found in the tradition of open public debate in Sweden where the economics profession has a strong and long-standing position. Economists are respected and regarded as important and constructive voices in the public sphere. Some of them have been extremely prolific in writing op-ed articles, serving as journalists and commentators in economics. This tradition goes back to the activities of Knut Wicksell, Gustav Cassel, Eli Heckscher, Bertil Ohlin and Gunnar Myrdal. They created a platform used by present generations of Swedish economists.

A government that ignores the voice of the Council runs the risk of losing credibility. Such a loss in credibility could also arise if the Government attempts to control or pressure the Council. The cost of such a loss serves to some extent as a guarantee of the Council's independence.

On the other hand, the Council must present professional analyses and well-founded recommendations in order to remain credible. The Council will not be able to maintain a solid brand-name if its performance is lacking. High credibility in turn fosters independence.

5.5 The impact of the fiscal framework

Sweden established a new fiscal framework after the crisis of the early 1990s. This raises questions about its effect on fiscal performance. A cursory glance may suggest that the framework has been successful. Government debt to GDP has fallen from a peak of above 70 percent in the mid-1990s to a level below 40 percent today (Chart 5). The trend seems to be towards still lower debt levels. The surplus target appears to have been met (Chart 8) and government expenditures have been kept below the expenditure ceiling, actually giving rise to a substantial budgetary margin, i.e. the difference between the expenditure ceiling and actual expenditures.

However, causality does not run in a simple unidirectional way from the framework to fiscal prudence. It is more complicated. The fiscal framework has evolved as part of a policy of fiscal stringency and prudence, colored by the experience of the crisis of 1991-93. The fiscal framework has been established to facilitate fiscal consolidation, by making it easier for the Government to argue for debt consolidation also in good times.¹³ The political will across party lines to strengthen the fiscal stance has contributed to the fiscal consolidation and to the establishment of the fiscal framework as well.

The most important building-block of the fiscal framework is probably the expenditure ceiling. Once it was introduced, it put an effective lid on the expansion of government expenditures and programs. Much suggests that it has served as the main instrument for the Ministry of Finance to keep the requests from the spending departments at bay. As it is expressed in nominal terms as a fixed sum, the expenditure ceiling has the advantage of being simple to understand and communicate to the parliament and to the public. It serves much more as a binding constraint than the surplus target which is defined “over the business cycle”. Such a concept is more elusive as it allows the Government more leeway in interpreting the degree of adherence to such a goal.

¹³ The impact of fiscal frameworks and fiscal policy councils on macroeconomic performance is the subject of several recent contributions. See for example Debrun, Gérard and Harris (2012), Schaechter et al (2012) and Wyplosz (2012).

It is too early to make any firm assessment of the impact of the Fiscal Policy Council as it has only existed since 2007. Still, in some areas, an effect may be noticed. The dialogue where the Government responds in the budget of September to the report of the Council from May the same year is one channel of influence. The Government has replied to a number of the recommendations put forth by the Council. As the Council has established a credibility of its own and is supported by all the political parties, there are likely to be political costs for completely ignoring its views.

It is proper to regard the fiscal framework, which encompasses the Council, as an attempt to create an institutionalized collective memory with the aim to keep the experience of the large and persistent budget deficits of the early 1990s alive in the minds of present and future policy-makers. It is thus a method of preventing a recurrence of the deficit policies of the past. The fiscal framework including the Council represents a new innovation. Time will tell which role it will play. It has not yet been put to a serious test in the sense that the Council has openly declared that the Government has made a serious breach of the fiscal framework.

6. Lessons concerning the fiscal framework

The record from Sweden suggests the following lessons concerning the new fiscal framework. Lesson-learning is not an exact science. The views below are based on my own reading of the literature on fiscal councils and my own experience with the Swedish fiscal framework from serving on the Council for three years.

1. The fiscal framework including the Fiscal Policy Council was adopted *after* the severe fiscal shock during the crisis in the early 1990s. This shock was the basic cause of the fiscal framework. The task of the framework including that of the Fiscal Policy Council should be to keep the memory of this shock alive in present and future fiscal policy debates
2. The fiscal consolidation process started *after* the financial and fiscal crisis of the 1990s and has continued since then. Timing is important when introducing a fiscal framework and a fiscal policy council. It should *not* be established in such a way that it prevents an effective response by the fiscal authorities during an acute economic crisis. Actually, a tight fiscal framework during the crisis of the 1990s could have served as a fiscal straightjacket that would have hindered a proper fiscal response to the financial crisis.
3. The fiscal consolidation process has been accompanied by falling long-term interest rates. Thus policy-makers have been rewarded by the financial market for their efforts. The task of a

fiscal framework including a fiscal policy council is facilitated by a well-functioning financial system that serves as a signaling device concerning the fiscal policy stance. A fiscal framework will under these circumstances represent a pro-market device.

4. A fiscal framework is likely to consist of a number of quantitative fiscal targets and constraints covering various time horizons. Here nominal government spending ceilings specified on an annual basis are likely to be more efficient from a political economy point of view than over-the-business cycle defined constraints and targets.¹⁴

The effectiveness of a fiscal policy council depends on several factors.

5. A fiscal policy council should be part of a fiscal framework. The task of a fiscal policy council is facilitated by the existence of a fiscal framework founded in law and/or in practice. The council can use such a framework as a benchmark for its analysis and recommendations concerning fiscal policy. Without a fiscal framework, a council faces a much more difficult mandate. It would be forced to select the proper fiscal rules to use, when judging the fiscal performance of the Government. Whatever it chooses, it will be more open to criticism and counter-arguments than in the case of an existing fiscal framework. It is comparable to a court or authority first writing the rules and then sentencing according to them.

6. The independence of a fiscal policy council is facilitated by the council being at a distance from the Government. Independence is promoted by not being directly involved in current policy-making, for example by supplying the Ministry of Finance with forecasts or other recommendations.

7. Independence is fostered by recruiting a majority of the members of the council from academia, preferably also foreign members. Members could also be selected from policy-makers and civil servants who have left active service and are expected to have no further career plans.

8. Consensus in society about a council is facilitated by a strong position of the economics profession in public discourse. The council will then be recruiting members who by themselves have a respected background.

¹⁴ This is also a lesson from the failure of the Stability and Growth Pact which was designed as a common European fiscal framework. See Larch, van den Noord and Jonung (2010).

9. A fiscal council can be a strong voice in public debate, serving as an educator of the public and of the political parties on fiscal issues, if the existence of a council is supported across party-lines. A council that is viewed as partisan will find it hard – if not outright impossible – to gain credibility. A consensus society like the Swedish one is likely to serve as a better background for a council than a country deeply divided across political party lines.¹⁵

10. The impact of a fiscal policy council depends on the economic policy culture or traditions of governance. If a country has a culture where the public holds a strong trust in public institutions, in government effectiveness and honesty, in the accountability of elected politicians, in the democratic process and in the rule of law, such an environment makes a fiscal council more effective. A fiscal council *per se* does not bring about immediate trust in public governance. However, a council may contribute in the long run to trust in the political system.

11. The fiscal framework including the Fiscal Policy Council in Sweden was created *within* Sweden in the domestic political process. Thus, it was not an import forced upon the country by outside pressure, like the present case in the euro-area where euro-area members are obliged to set up independent fiscal authorities. A fiscal framework that is created domestically is likely to have a wider public acceptance and a stronger impact than one established “from the outside”.

12. Finally, creating new institutions and making them trustworthy in the eyes of the public is a time-consuming trial-and-error process. Mistakes will be made. A new fiscal policy council should not be expected to have an immediate impact.

7. Conclusions

The Swedish experience of policy-learning and policy reforms since the early 1970s give rise to a number of conclusions. First of all, policy learning is a continuous process. The process has not ended. It will continue, thus implying that we should expect new reforms concerning the goals, instruments and institutional framework for macroeconomic policy. New crises and new research will bring about changes.

¹⁵ This suggests that a country like the US for the moment lacks an important prerequisite for an effective fiscal council as it is sharply divided politically.

Second, it is important to have the capacity to learn from past mistakes. The Swedish record suggests that an open debate involving policy-makers and economists fosters improvements in fiscal policy making.

Third, the fiscal experience of Sweden can serve as a source of inspiration for countries now searching for new ways to achieve stable government finances. Of course, the Swedish framework cannot be copied by other countries without paying attention to country-specific institutional circumstances. Still, several lessons can be condensed from the Swedish experience. A basic one is that a fiscal framework is a method for maintaining a collective memory of the dangers of fiscal overexpansion. A fiscal policy council may serve as a guardian that defends and develops the fiscal framework, that warns against the dangers of relying on deficit financing, and that educates the public and the politicians about fiscal policies. Serving this task, a council can foster the workings of a democratic society.

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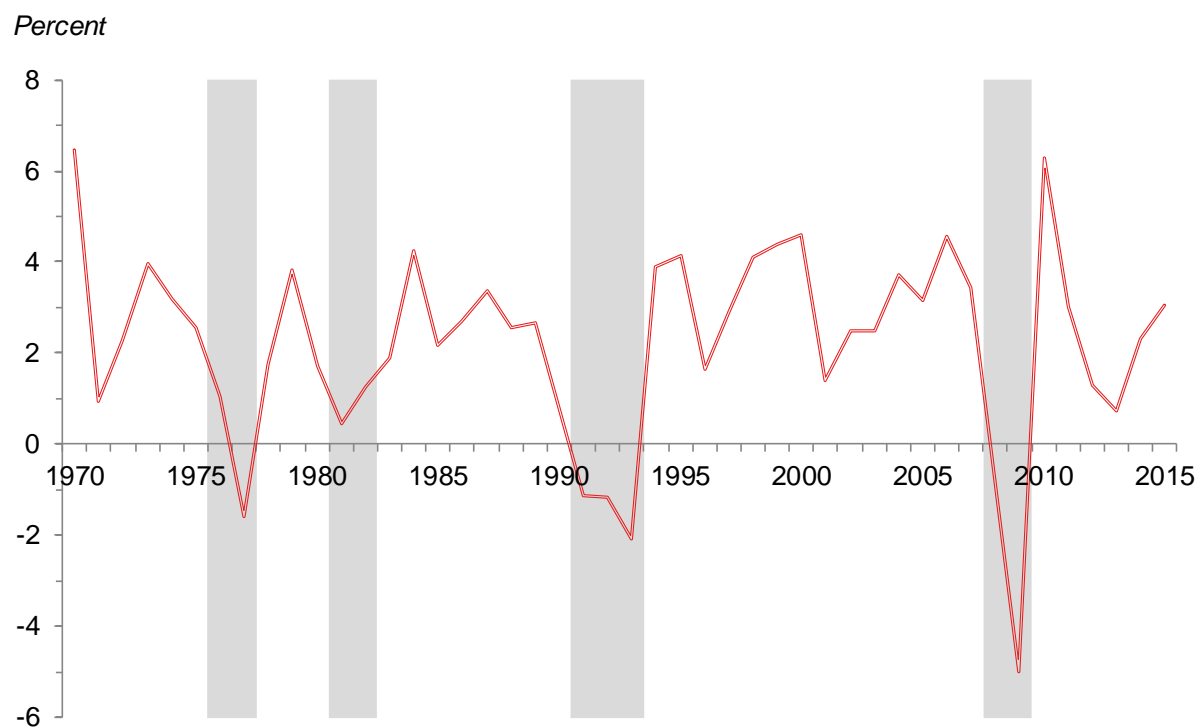
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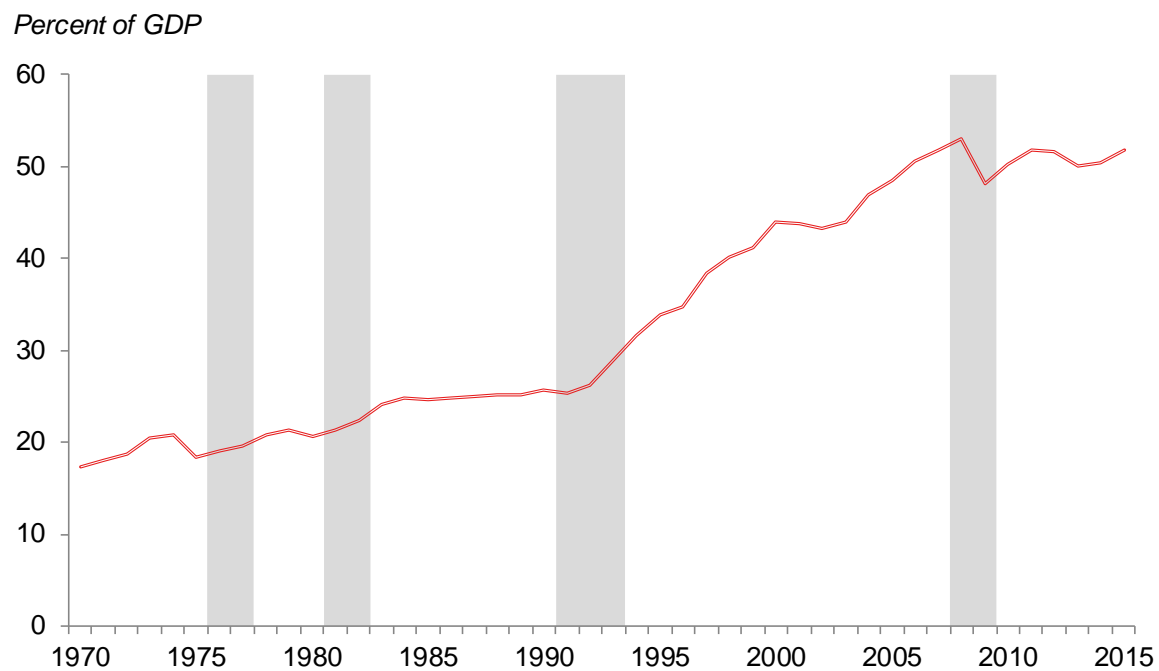
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Chart 1. Economic growth (annual percent) in Sweden 1970–2015

Source: OECD Economic Outlook No 94.

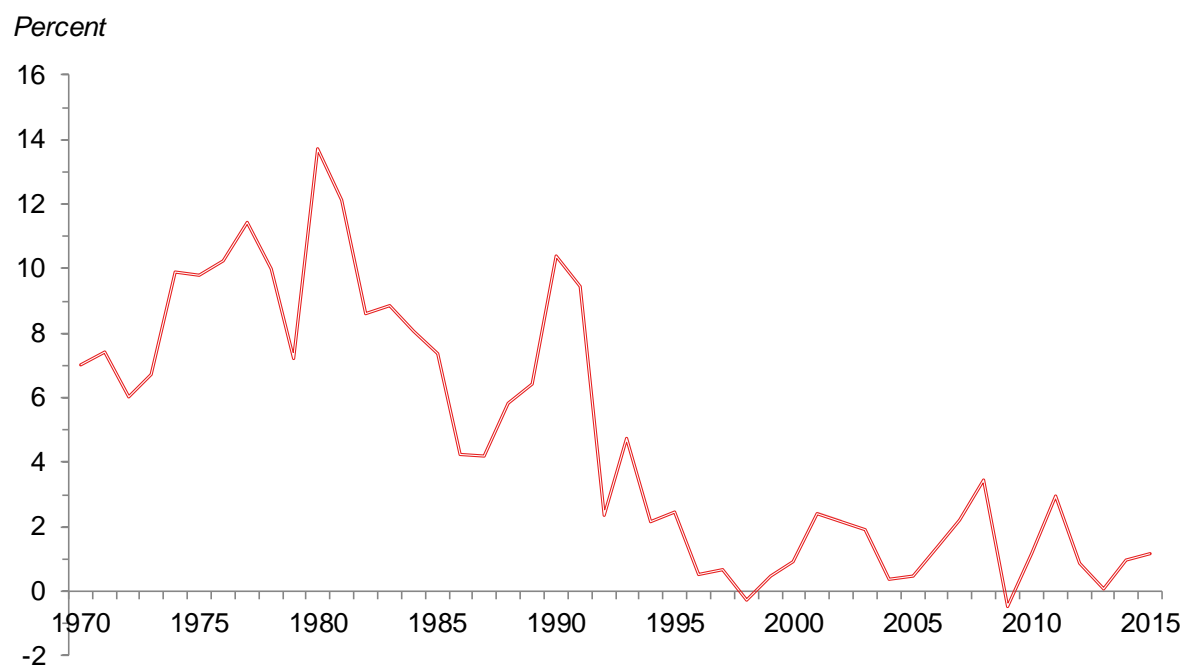
Comment: The shaded years represent years of recession. Data for 2013–2015 is based on forecasts.

Chart 2. Export of goods and services (percent of GDP, constant prices) in Sweden 1970–2015



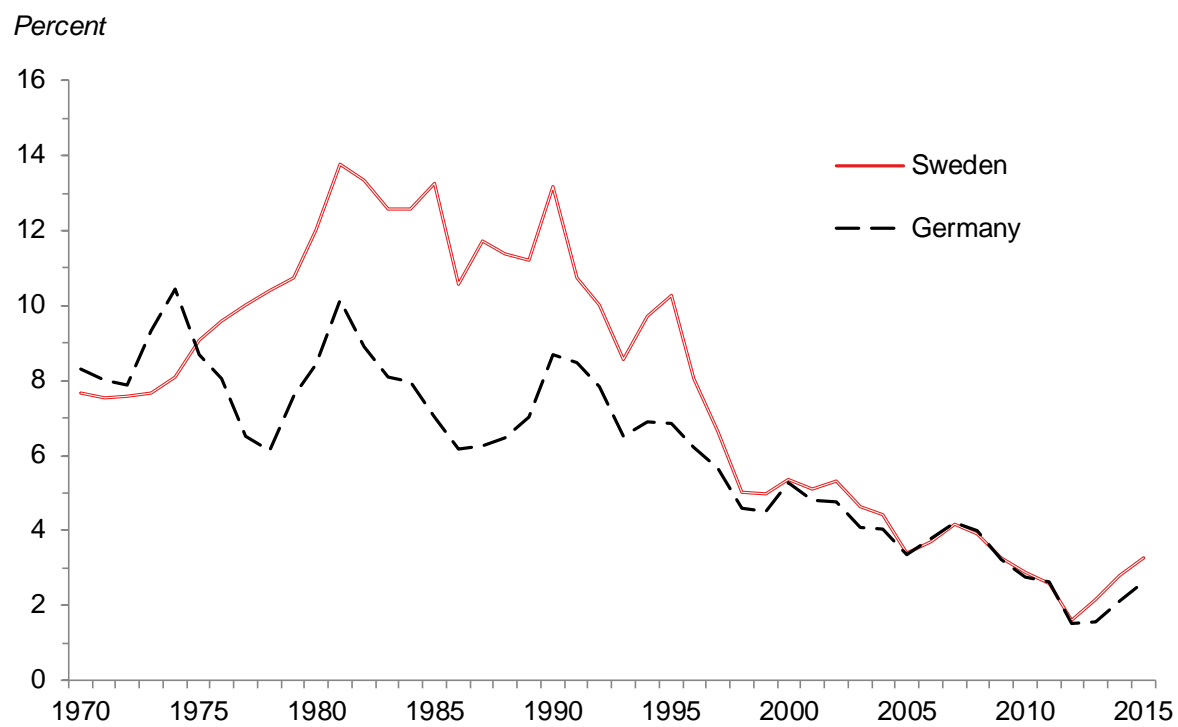
Source: AMECO.

Comment: The shaded years represent years of recession. Data for 2013–2015 is based on forecasts.

Chart 3. Rate of inflation (annual percent) in Sweden 1970–2015

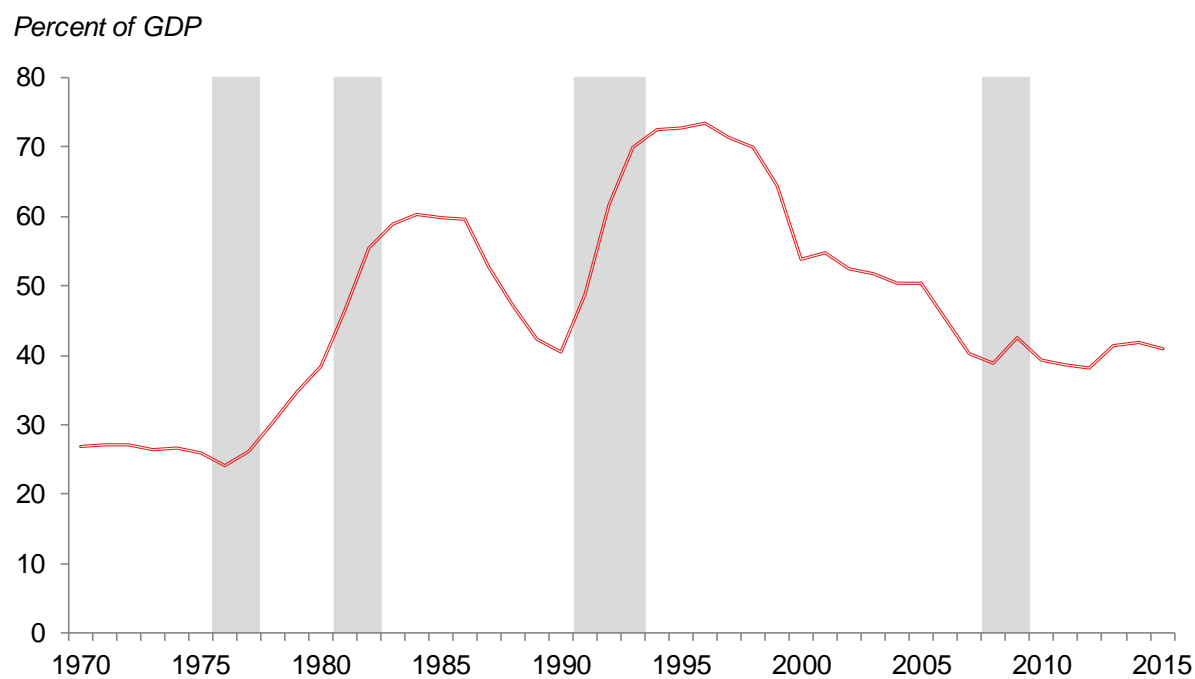
Source: OECD Economic Outlook No 94. Data for 2013–2015 is based on forecasts.

Chart 4. Long-term interest rate on government bonds (percent) for Sweden and Germany 1970–2015



Source: OECD Economic Outlook No 94.

Comment: Prior to 1991, the data for Germany refers to West Germany. Data for 2013–2015 is based on forecasts.

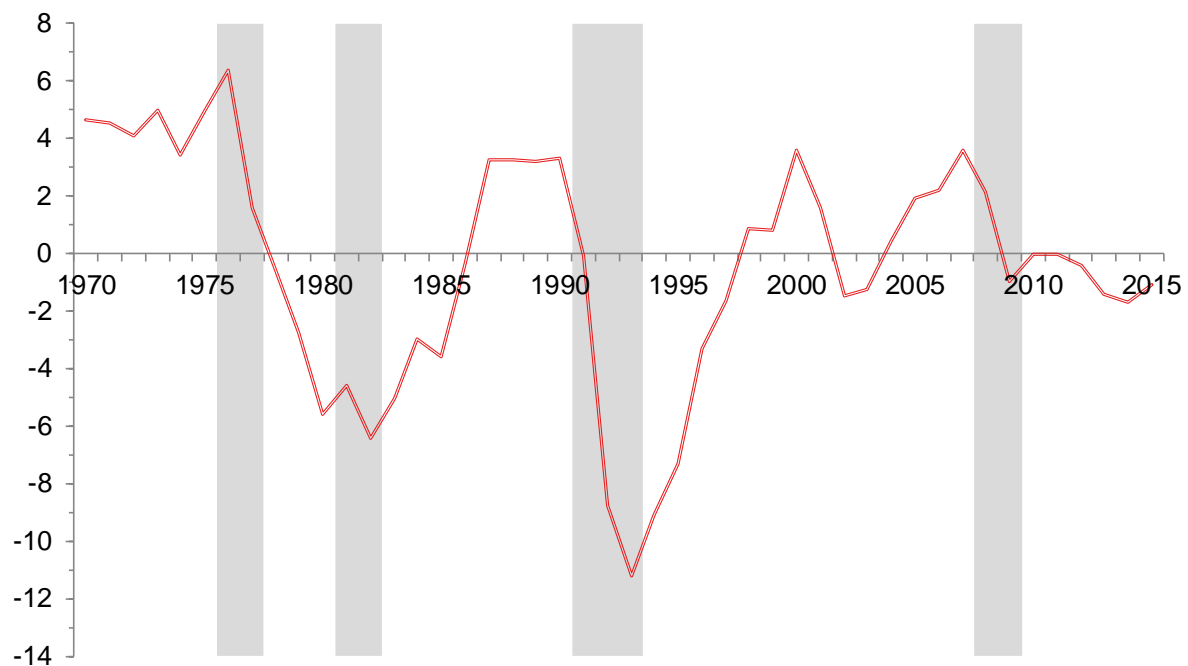
Chart 5. General government gross debt (percent of GDP) in Sweden 1970–2015

Source: AMECO.

Comment: The shaded years represent years of recession. Data for 2013–2015 is based on forecasts.

Chart 6. General government net lending (percent of GDP) in Sweden 1970–2015

Percent of GDP

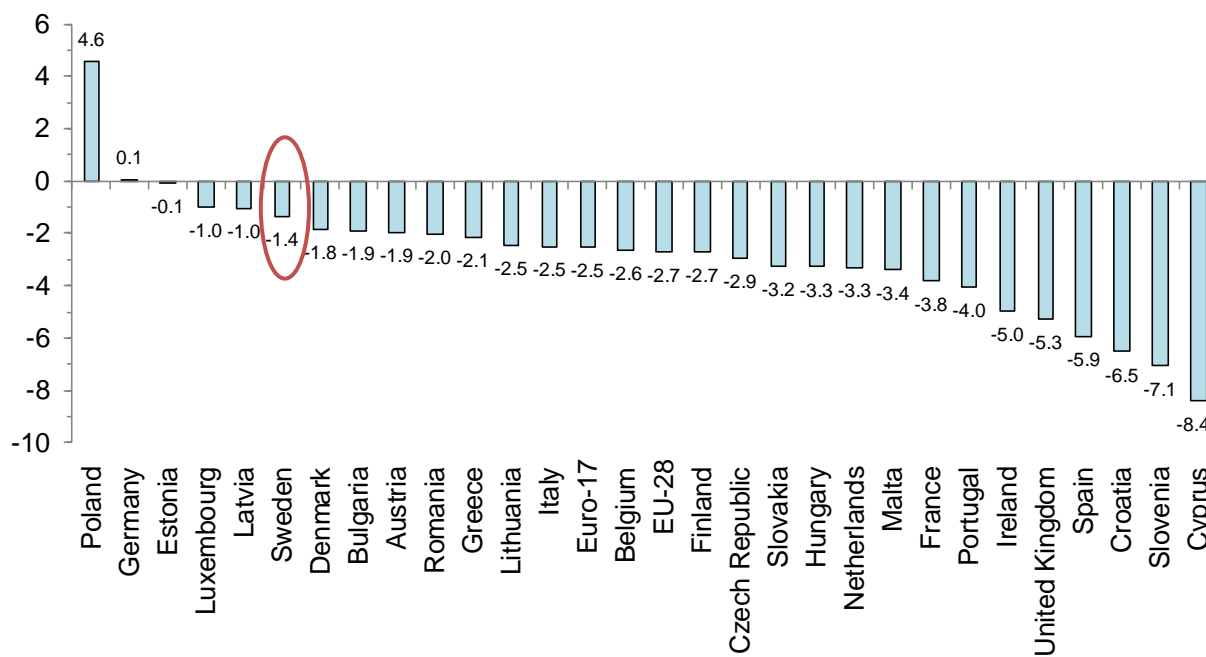


Source: AMECO.

Comment: The shaded years represent years of recession. Data for 2013–2015 is based on forecasts.

Chart 7. General government net lending (percent of GDP) for EU-members 2014

Percent of GDP



Source: AMECO.

Comment: Forecasts for 2014.

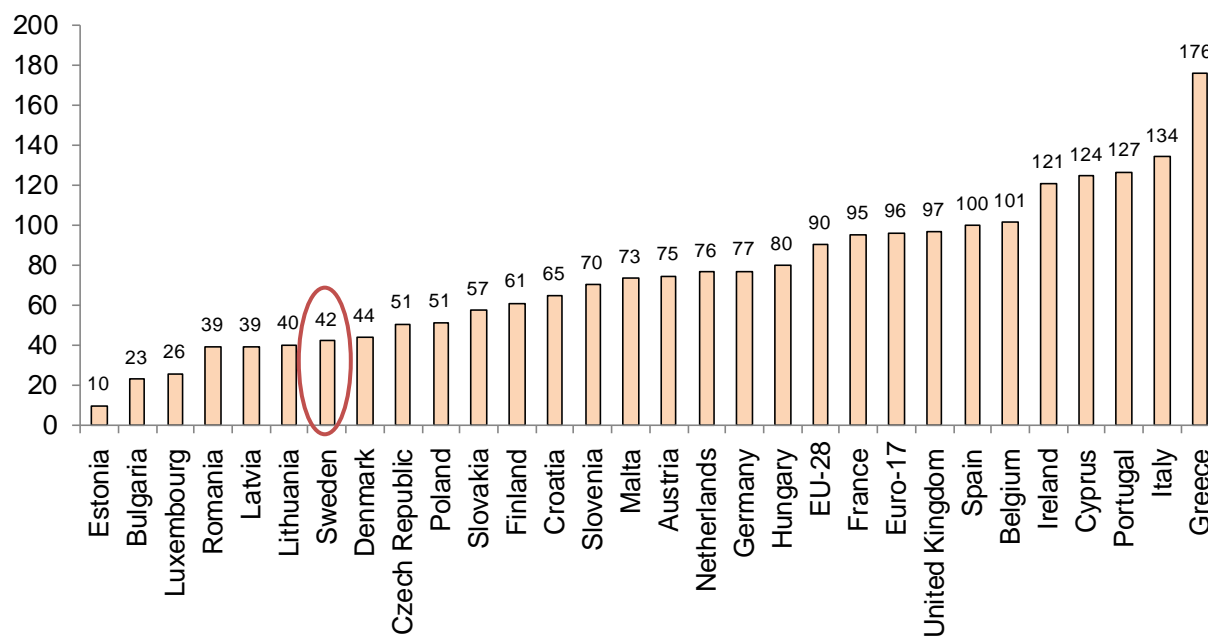
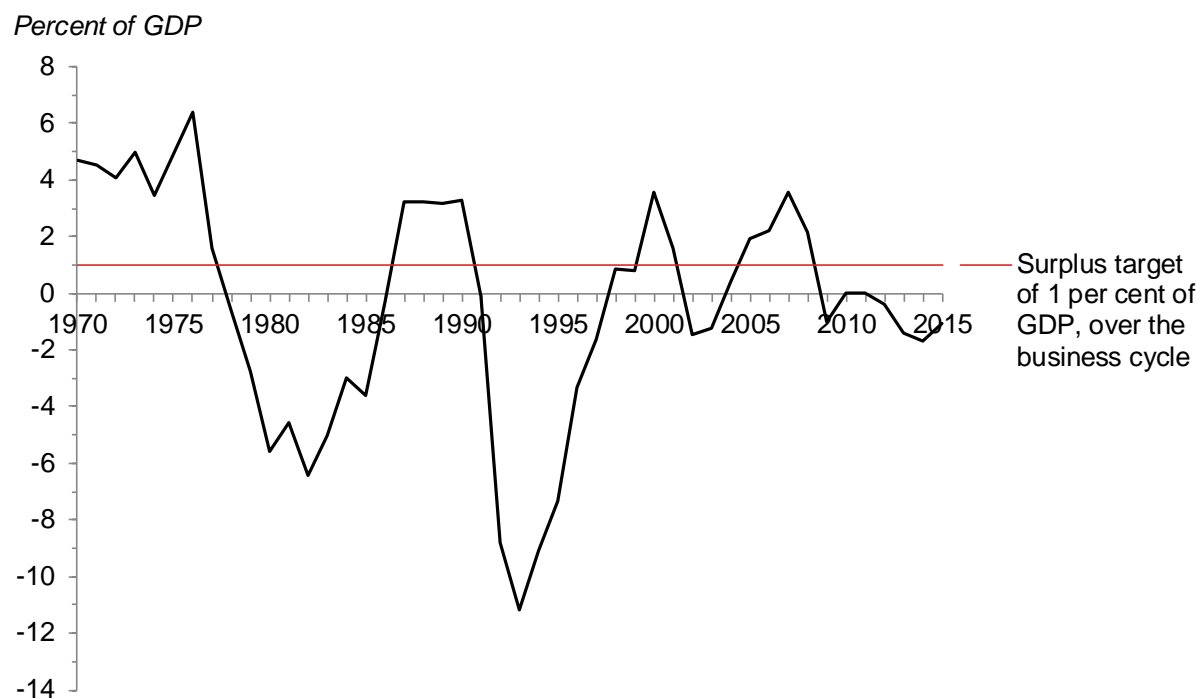
Chart 8. General government gross debt (percent of GDP) for EU-members 2014*Percent of GDP**Source: AMECO.**Comment: Forecasts for 2014.*

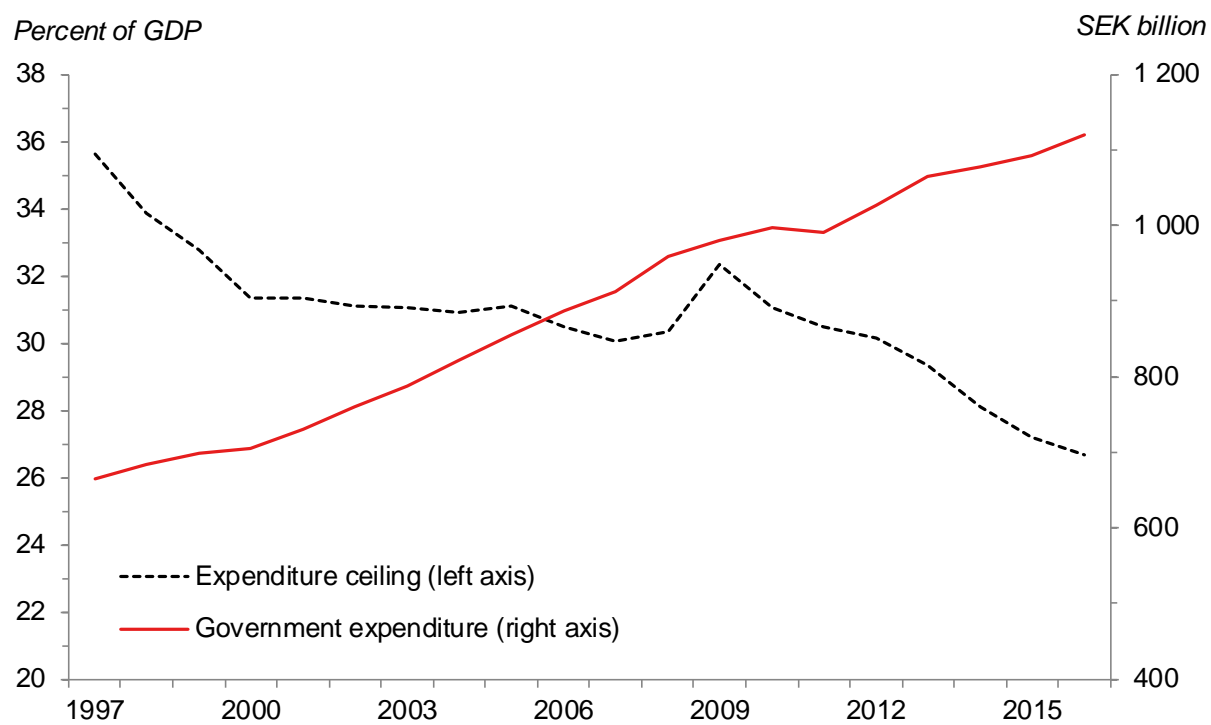
Chart 9. General government net lending (percent of GDP) in Sweden and the surplus target 1975–2015



Source: OECD Economic Outlook No 94.

Comment: Data for 2013–2015 is based on forecasts.

Chart 10. The expenditure ceiling (percent of GDP) and government expenditure (billion SEK) 1997–2016



Source: The Swedish Ministry of Finance.

Comment: Data for 2014 and 2015 are based on forecasts.

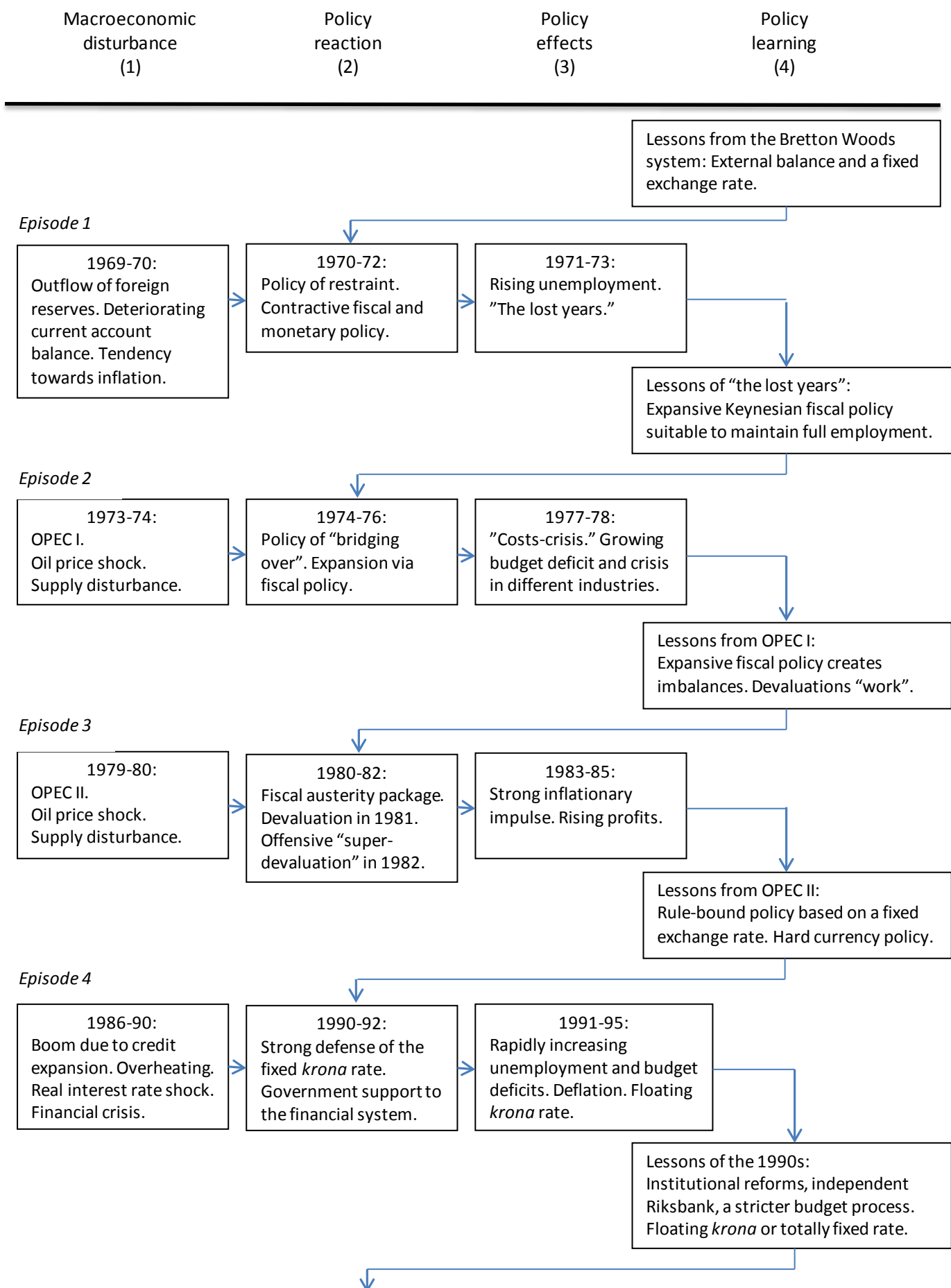
Table 1. The policy learning process 1970-2013. A stylized picture.

Table 1 continued

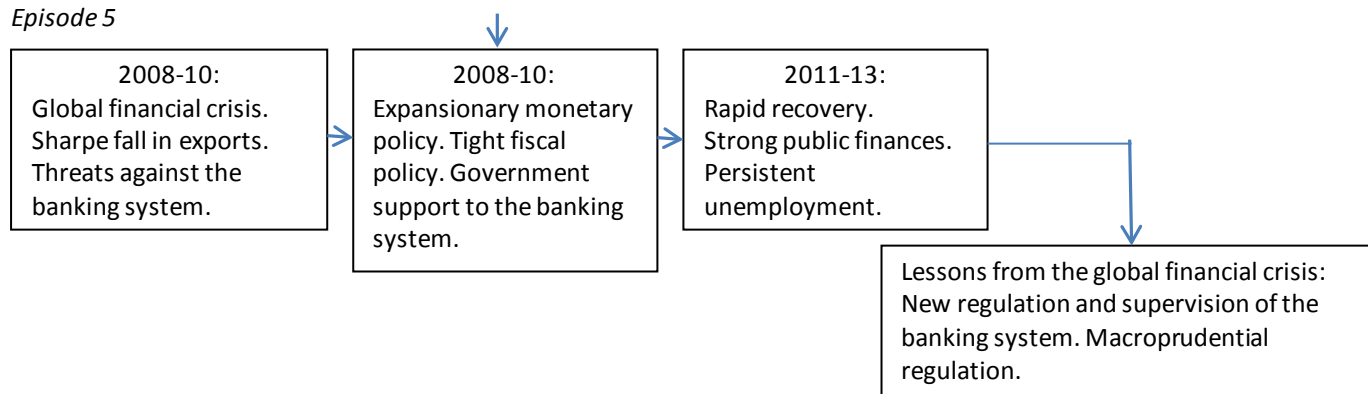
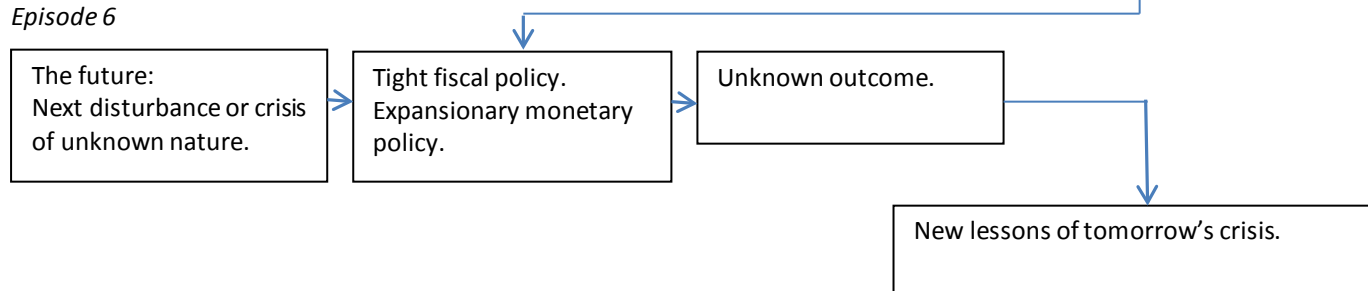
Episode 5*Episode 6*

Table 2. The evolution of the Swedish fiscal framework 1995-2011

Since 1995: *Top-down approach* for the central government budget.

Since 2000: *Surplus target*. General government net lending is required to show a surplus of 1 percent over the course of a business cycle. A buffer for economic fluctuations and demographic changes.

Since 1997: *Central government expenditure ceiling* (for the third year ahead in the Budget Bill, with a *budget margin* acting as a buffer).

Since 2000: *Balanced budget requirement* for local governments.

Since 2007: A *fiscal policy council* is established.

Since 2011: A new instruction for the fiscal policy council is given.
