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Jonung, Lars

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

Abstract: This paper derives a set of policy lessons for Portugal from the new fiscal framework including a fiscal policy council that gradually emerged in Sweden after the deep economic crisis of the early 1990s. By now, Swedish public finances stand out among the strongest in Europe. Recent Swedish macroeconomic performance has been impressive. As Sweden and Portugal are small open economies in the periphery of Europe, Sweden may serve as a fiscal model for Portugal. Policy lessons are distilled from the Swedish experience for Portugal, stressing the importance of the economic policy culture for macroeconomic outcomes and for trust in government institutions and policies.

Key words: Fiscal rules, fiscal policy council, fiscal policy, public debt, Sweden, Portugal.

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

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PT/OBancoeoEurosistema/Eventos/Documents/VolumeProceedings.pdf.

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The Swedish Experience of Fiscal Reform. Lessons for Portugal

1. Introduction[1]

Due to the global financial crisis, a large number of countries in Europe are now experiencing major problems with unsustainable government finances with high and rising deficits and debts. Portugal belongs to this group. There are a few exceptions to this pattern. Sweden is one of them, actually displaying strong public finances reflected in a falling debt ratio since the outbreak of the crisis in 2008.

This was not the case for Swedish public finances during crises in the past. In the early 1990s Sweden experienced a deep economic downturn causing a sharp drop in real income, a rapid rise in unemployment and huge government deficits and consequently a substantial rise in government debt. It was a banking crisis, a currency crisis and a fiscal crisis concomitantly. This was a major shock to a country proud of its record of full employment and of a successful welfare state.

The crisis set off a process of lesson-learning concerning economic policies and the rules for policy-making. The framing of monetary and fiscal policies was significantly changed. A new fiscal framework was established, fundamentally different from that in place prior to the crisis. A number of structural reforms were implemented.

The reform process was accompanied by a long recovery lasting for two decades up till today. Actually, the improvement in economic performance since the crisis of the 1990s has been a boon to the Swedish economy during the recent global depression. In the OECD Economic Survey of Sweden published in December 2012, the executive summary opens in the following way:

The Swedish economy has exhibited resilience in the face of international turbulence, thanks to sound macroeconomic policies and substantial structural reforms carried out since the early 1990s.[2]

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[1] Johanna Modigsson has skillfully prepared tables and charts. Niklas Frank, Sean Kenny, Eva Lindström, Per Molander, Tomas Nordström, Joakim Sonnegård, Hans Tson Söderström and Lisa von Trapp have provided constructive comments. This paper was written when the author was the chairman of the Swedish fiscal policy council. The usual disclaimer holds.

[2] OECD (2012, p. 9).

The purpose of this paper is to give an account of the fiscal framework that gradually emerged in Sweden after the crisis of the 1990s, useful for distilling a set of policy lessons for a country like Portugal.

The paper is organized in the following way. First, the recent macroeconomic record of Sweden is summarized and compared to that of Portugal as well as that of other OECD-countries. This comparison demonstrates that Swedish government finances have been much stronger than in almost all other countries in Europe. The Swedish fiscal record invites a number of questions: why did the fiscal framework emerge, what are the main features, what has been the impact on actual policies, how robust is the fiscal framework and which features could be exported to other countries? The remaining sections of the paper attempt to provide answers to these questions.

The focus of the paper is on the Swedish Fiscal Policy Council. The reason is that in recent years a number of countries have established independent "non-political" fiscal policy institutions or councils assigned to monitor and survey the conduct of fiscal policy. Such institutions have actually existed in countries like the Netherlands and the US for a considerable time. As seen from Table 1 various forms of fiscal policy councils can be found in about 15 countries. The number is expected to grow in the near future as the EU, IMF and OECD are recommending fiscal policy councils. As a result of the European debt crisis, the European Union is presently requiring such councils to be set up in euro-area member countries. This is the reason why a council was recently established in Portugal.

The basic idea behind the thrust towards independent fiscal councils is that they are expected to reduce the deficit bias characterizing economic policies in many countries. In short, the tendency of democratic societies to run persistent budget deficits, creating rising public debt, and in some cases leading to unsustainable debt levels may be dampened by independent fiscal authorities. At this stage, it is an open question to what extent such institutional arrangements will actually prove successful.

It must be stressed that the idea behind an independent fiscal council is *not* to hand over the actual conduct of fiscal policy to independent experts. Such a step would undermine the democratic process. Fiscal policy is inherently a very political issue as decisions concerning taxes and government revenue directly impact upon the distribution of income and wealth. These decisions cannot be delegated to experts to the same extent as decisions concerning monetary policy. Rather, the idea behind a fiscal policy council is to improve the quality of the budgetary process by having an independent institution monitoring the conduct of fiscal policy and by reporting to the government and to the public. In this way the workings of a democratic society can be improved upon.

2. The macroeconomic record of Sweden and Portugal

There are several similarities between Sweden and Portugal. Both countries should be classified as “small open economies” as this term is used in the textbooks in economics. The Swedish population is slightly below 10 million. The Portuguese number is slightly above that number (Table 2). The share of exports to GDP in Sweden is around 50 per cent. The corresponding figure for Portugal is close to 40 per cent (Table 2).

Both countries are placed in the periphery of Europe. They remained outside World War I and II being neutral. Both are EU members. Portugal joined in 1986, well ahead of Sweden in 1995. Both were founding members of EFTA (European Free Trade Association) in 1960 – a free trade association, the outer seven, once set up as a counterweight to the European Economic Community, at that time the inner six.

Turning to the macroeconomic record of the past 10-20 years, a number of differences emerge. Swedish GDP per capita income is almost three times as large as the Portuguese income (Table 2). Using data adjusted for purchasing power, the difference is considerably smaller; Swedish income drops to less than twice the Portuguese level. On top of that, Swedish growth performance has been strong by international comparison. Total GDP growth in the past ten years has been higher than in the euro area, in the UK, in the OECD, the United States and Canada (Chart 1). The same holds for the period 2007-2012 which covers the recent global financial crisis. Swedish growth remained resilient during the global financial crisis. It stayed at 4.6 per cent average annual growth during 2008-2012, while the same number was -0.3 for Portugal (Table 2).

High economic growth has been accompanied by high employment growth in Sweden compared to most EU members except Germany (Chart 2). The employment rate has remained high as well (Chart 3). The Swedish unemployment rate is by now half that of Portugal; 7.5 per cent compared to 15.5 for Portugal (Table 2).

Inflation has been roughly the same in the two countries (Table 2). Long-term interest rates were at the same level from the mid-1990s to the start of the recent global recession (Chart 4).

From then on they have diverged. The Portuguese rate rose dramatically while the Swedish rate continued to fall. It is now below 2 per cent.

The current account displays a major difference (Table 2). The Swedish account was positive in 2012 (+6.4 per cent) – and has been positive for a long time - while the Portuguese account is presently negative (-3.0 per cent).

A striking difference between the two countries concerns government finances. Since the mid-1990s, government gross debt as a share of GDP has fallen from around 70 per cent to around 40 per cent in Sweden. During the same period it doubled in Portugal from a level around 60 per cent to about 120 percent in 2012 (Chart 5). The rise in the Portuguese debt ratio is most pronounced during the recent global crisis. Presently the budget deficit (general government net borrowing) is close to zero in Sweden while it is around 5 per cent of GDP in Portugal (Table 2).

The Swedish public finances are strong in an all-EU member countries comparison as well. General government net lending for 2013 is just below that of Germany (Chart 6). General government gross debt as per cent of GDP is among the lowest in the EU (Chart 7).

This comparison of the long-run economic record between Sweden and Portugal points to two major differences: a higher growth rate and stronger public finances in Sweden since the mid-1990s. Most worrying, the recent global crisis has attenuated the differences between Sweden and Portugal. These divergent trends become more pronounced during the past three-four years.

To account for the macroeconomic differences between Portugal and Sweden and to understand the policy challenges facing the two countries, we should also pay attention to the wider framework within which economic policies are generated. This framework includes the quality of government, the traditions of governance and the public's perception of the workings of the political system and of the public sector.

Here there are major differences between Portugal and Sweden. Public trust in the political system differs sharply across the two countries as seen from Table 3 displaying public trust in the political parties, the government and the parliament in Portugal and Sweden as reported in the Eurobarometer from the fall of 2012. The Swedish respondents display much more trust in their political system than their Portuguese counterparts. Likewise, satisfaction with the way democracy works is much stronger in Sweden than in Portugal (Table 3). Cross-country differences emerge also from Table 4 displaying a set of indicators of governance performance: government effectiveness, voice and accountability, regulatory quality, rule of law and control of corruption. As a consequence, confidence in the national government is much stronger in Sweden than in Portugal.[3]

Table 3 and 4 do not give a balanced picture as Portugal is presently suffering from deep economic problems while Sweden so far has managed to avoid a sharp downturn. An economic crisis per se reduces trust in the political system. We should also keep in mind that Portugal made the transition from dictatorship to a democracy in the 1970s while democracy has its roots further back in Swedish history. Still, Table 3 and 4 suggest that the “policy culture” in Sweden is more conducive to reform than in Portugal. Swedish authorities have a large degree of public trust which is likely to make it easier to design and implement policies.

3. The new fiscal framework after the crisis of 1992

The above comparison between Portugal and Sweden demonstrates that Sweden has followed a trajectory sharply different from that of most EU-countries concerning fiscal performance. How can this divergence be explained? To explain the fiscal performance and the fiscal reforms of Sweden during the past 20 years, it is crucial to go back to the deep economic crisis of the early 1990s and its impact on the response of policy-makers and on the electorate.

3.1. The crisis of 1992-93[4]

Western Europe experienced a severe recession, manifested in the European currency crisis in the autumn of 1992 and summer of 1993. The recession turned most severe in Sweden where it followed a typical boom-bust pattern.

The impulse to the boom should be traced back to November 1985, when the Swedish central bank, the Riksbank, decided to deregulate the domestic credit market. However, the Riksbank maintained a fixed exchange rate for the krona, the Swedish currency. During the following years, a sharp rise in the demand for and supply of credit took place. The real rate of interest adjusted for taxes, inflation and inflationary expectations became negative. The price of

[3] A similar picture emerges from a study of the quality of government within EU member states produced for the European Commission. Here Sweden ranks as number 2 and Portugal as number 14 on a composite measure of the quality of government. See Charron, Lapuente and Rothstein (2011, p. 30).

[4] This section is based on chapter 2 in Jonung, Kiander and Vartia (2009).

shares and housing rose quickly as no monetary or fiscal countermeasures were taken during the years 1986-90.

The boom peaked in 1991, when the bubble started to burst. Sweden went into a deep downturn. Private sector savings increased markedly, demanding an adjustment via decreased public savings and/or via a change in the rate of the krona, i.e. through a depreciated exchange rate.[5] A sharp rise in the real rate of interest undermined the stability of the financial system. Investment, in particular within the construction sector, collapsed. At the same time, unemployment increased.

The budget deficit rose dramatically, becoming one of the biggest within the OECD-area due to the workings of the automatic stabilizers as well as costly support to the banking system (Chart 8). Real national income declined three years in a row – a unique pattern without parallel in Sweden during the 20th century. The acute crisis was arrested when the Riksbank was forced to abandon the fixed exchange rate of the krona in November 1992, allowing the krona to float. It has been floating since then.

When the fixed exchange rate was abandoned, the krona sharply depreciated. This contributed to a rapid rise in exports, eventually pulling Sweden out of depression. The share of exports to GDP almost doubled between 1992 and 2012 (Chart 9). Swedish economic growth rose to a high level during the past 15 years with exports as the main engine of growth (Chart 10). A number of structural reforms, covering a wide set of areas and implemented in the wake of the crisis, contributed positively to growth as well.

3.2. The emergence of the fiscal framework

The crisis caused a sharp rise in the budget deficit and in government debt (Chart 5 and 8). The huge deficits emerging became an embarrassment to the center-right government in power during the financial crisis of 1992-93. Fiscal consolidation became a top priority on the

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[5] The budget deficits that arose during the crisis of the 1990s can be viewed as the outcome of a policy of tax smoothing. According to this theory, when a large unexpected disturbance hits the economy, the government should increase its borrowing to smooth the tax burden over time. A negative disturbance of the type that occurred in the Swedish economy in the beginning of the 1990s should first be counteracted by an increase in central government debt, not with increased taxes or reduced government expenditures. Such measures would aggravate the crisis. However, after the crisis measures should be taken to reduce government deficits and government debt. In hindsight, Sweden followed such a tax smoothing policy during the 1990s.

political agenda of the Social Democratic government that came into power after the election in the fall of 1994. It built a reputation of being a competent and careful manager of government finances when in power during 1994-2006. A major goal during this period was to reduce the budget deficit and lower the government debt to national income ratio. Here the government was successful as seen from Chart 5 and 8.

Eventually, as a response to the crisis, a fiscal framework was constructed in a political and administrative process covering several years. Actually, this process still continues.[6] A first step was a report published in 1992 by ESO, a think-tank of the Ministry of Finance. This report, put together by Per Molander, at that time a civil servant in the Ministry of Finance, 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 full coverage for the financing of government expenditures. The report was inspired by a study by Jürgen von Hagen (1992) demonstrating that the Swedish budgetary process was one of the weakest in the EU, next to that of Italy.[7]

The ESO report contributed to a parliamentary reform in 1994 encompassing a top-down approach where the Parliament first decides the total volume of expenditures and then the distribution of expenditures across 27 specific expenditure areas. The calendar year became 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.[8]

In 1998, a *surplus target* for general government net lending was introduced, to be implemented from 2000. Public finances are now required to show a surplus of 1 per cent over the course of a business cycle for the whole public sector (Chart 8). The surplus target is 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.

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[6] The emergence of the Swedish fiscal framework is covered in several contributions. See Calmfors and Wren-Lewis (2011) and Molander (1999). A recent summary is found in Jonung (2014).
[7] The report is von Hagen (1992). It was later extended in von Hagen and Harden (1994).
[8]

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 a new budget act stipulated that the use of the expenditure ceiling and the surplus target was mandatory. The build-up of the fiscal framework 1995-2007 is summarized in Table 5.[9]

3.3. A fiscal framework based on rules and practice

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 some fundamental principles or rules for fiscal policy. Some are governed by law as displayed in Table 5 while others follow a practice that has developed 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 per cent of GDP over the business cycle. Under the Budget Act, the Government 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 has set a cap in nominal terms for government expenditures, reducing them measured as a share of GDP (Chart 11). So far, the expenditure ceiling has not been revised upwards except for minor technical adjustments. It is worth stressing that the ceiling has not prevented government expenditure to grow in nominal terms over time (Chart 12). 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

[9] 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.

about half of total government spending. They represented slightly more than 20 per cent of GDP. The balanced budget rule stipulates that each municipality and county council must plan for a balanced budget.

The Government has also drawn up 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 Government rules out the use of active (discretionary) fiscal measures as standard tools for stabilization policies. Instead, the main countercyclical effect of fiscal policy is provided via the automatic stabilizers. However, very large demand and supply shocks may require an active fiscal policy response to limit the rise in unemployment. Financial crises may also require special measures to maintain financial stability. Losses that may emerge in the financial sector should primarily be borne by financial institutions, their shareholders and others who have contributed risk capital.

4. The Fiscal Policy Council

By now the Fiscal Policy Council is probably the element in the Swedish fiscal policy framework that has attracted most interest. The Council so far represents the last major step in a process that should properly be classified as a learning process – in short learning from the crises of the past.[10]

4.1 The establishment of the Fiscal Council[11]

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.[12] No legislative

[10] The process of policy learning from crises during the period 1970-1995, covering monetary as well as fiscal policies, is described in Jonung (1999).
[11] Accounts of the Swedish fiscal policy council and its impact are found in i. a. Calmfors (2010), 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 Council (2012).
[12] Wyplosz (2002) prepared a contribution on fiscal policy councils to the commission. His piece inspired the commission in its recommendations.

step towards a council was taken, however. The Social Democratic government expressed no interest. In the referendum in 2003 on Swedish euro membership, a majority voted no to joining the euro. Thus, Sweden stayed with its national currency, the krona.

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, Anders Borg, a fiscal policy council was established one year later. The initiative first met 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".[13]

The first report of the Council was published in 2008, since then followed by annual reports 2009-2012. Gradually, the Council has established a reputation by itself 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. Thus, the initial skepticism of these parties has turned into support of the Council. It is fair to say that the Council is now well entrenched in the Swedish political system in the sense that it has the backing of seven out of eight parties in the Parliament.

The Council is set up as an agency under the Government, directly under the Ministry of Finance (Chart 13). Its budget is determined by the Ministry of Finance and thus by the Government. The Council has a small secretariat made up of five persons. The annual budget is 9 million SEK, approximately 1 million euro. The Council is thus a very small body by international comparison.[14] The Council, however, has the option of asking outside experts to prepare reports on issues of interest. These usually serve as inputs 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 is made up of 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 per cent) basis, as a supplementary activity to their ordinary jobs or positions. The Council is in principle a self-

[13] Calmfors and Wren-Lewis (2011, p. 682).
[14] See the comparison of the tasks of various fiscal councils in Table 2 in Calmfors and Wren-Lewis (2011).

perpetuating body. It recruits itself in the sense that it proposes to the Government replacements for members who are leaving.

4.2 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 remit 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”.[15]

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,
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.

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

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 policies 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 around 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.

4.3 The Council's reports 2007-12

The main tool of the Council for communicating its message is the annual report. It is published in mid-May. At that occasion, the full Council meets with the Minister of Finance. The same day the report is presented to the media. The next day, the Council arranges a public meeting, with invited commentators, dealing with the annual report. 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 gives his/her response 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 five annual reports produced in 2007-2012 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.

To give a flavor of the issues dealt with in the annual reports, it is useful to look in some detail into the 2012 report of the Council.[16] The first chapter concluded that fiscal policy generally was successful and, on the whole, well balanced. This claim was supported by a comparison with other EU-countries’ economic policy experience since the outbreak of the global crisis in 2008. The fiscal policy pursued in 2011 and 2012 has complied with the current fiscal framework. There is little risk of expenditure exceeding the expenditure ceiling in the next few years.

After this initial positive overall evaluation, the Council presented several critical viewpoints, in regards to at least 19 issues. The Government should provide a better explanation of how the scope for new policy initiatives arises and how it is divided between taxes and expenditures during the near future. The Council objected to the fact that tax cuts announced by the Government in spring 2011 were not proposed in the Budget Bill of September 2011 for 2012.

In the budget bill for 2012, the Government referred to the macroeconomic uncertainty as an argument for larger safety margins – in addition to the margin already built into the fiscal framework. The Council argued, in response, that a regular use of safety margins may create an undesirable procyclical element in fiscal policy and thus bring the average government net lending to exceed the surplus target.

The Council stressed that rapidly expanding credit and rising property prices imply macro-financial risks for the Swedish economy which should not be underestimated. The

[16] See Swedish Fiscal Policy (2012).

Government should decide how macro-prudential regulation and supervision should be strengthened to reduce the risk of future financial crises.

The Council noted that the surplus target implies the stabilization of general government net financial wealth as a percentage of GDP. The level at which it is being stabilized depends on changes in the valuation of government assets outside the fiscal framework. Further accumulation of net wealth exceeding the current 20 per cent of GDP is difficult to justify with the need for safety margins in case of an economic crisis. The Government should clarify its view of the appropriate size of government net wealth and the overall principles to apply in the trade-off between the risks of the government portfolio and its expected return.

One chapter on generational accounting demonstrated that Sweden's public finances are sustainable in the long run. A strong contributing factor is the design of the pension system with an automatic balancing mechanism that reduces pensions if the stability of the pension system is threatened. The Council concludes that the pension system is financially stable – but asks the question whether it is politically stable if replacement ratios fall sharply?

The major expenditure measure in the Budget Bill for 2012 concerned a reduction in the value-added tax (VAT) on restaurant and catering services. On this issue, the Council argued that the positive employment effects from a lower VAT estimated by the Government were most likely too optimistic. The Council regarded the lower VAT as a support to a specific sector. This increases the risk of other pressure groups lobbying for sectoral support. If more sectors were to benefit from reduced VAT-rates, there is a risk of undermining the tax base represented by the VAT. A uniform VAT, instead, would most likely have large positive economic effects to society.

Many of the issues brought up by the report of the Council attracted the interest of the media when the report was published. Many of the issues remain in the public debate. The report is cited and referred to long after the initial publication (Chart 14).

4.4 The independence of the Council

In the public debate, representatives of the Council have described the Council as a watch-dog that barks when fiscal sustainability is threatened by the economic policies of the Government. The Council should serve as an early warning system for fiscal disasters. Can it fulfill this function when it is financed by the Ministry of Finance? It has been suggested 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 (Chart 13).

So far, the general view appears to be 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. They have served on government commissions, been employed as civil servants and been active in party politics. Some of them have been extremely prolific in writing op-ed articles, in short 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, all professors in economics who were very active and visible in the public debate and public life.[17] They created a platform used by present day 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.

[17] See Carlson and Jonung (2006) for the roots of the strong position of the economics profession in Sweden.

4.5 Challenges for the Council

The Council got a new mandate in 2011 which included a new task, namely to analyze the distributional effects of the economic policies of the Government. This is an intellectual challenge as textbooks in economics do not give clear guidance on how to evaluate trade-offs between policy measures that improve efficiency or stabilization while at the same time impacting, usually negatively, on the distribution of income and wealth in society.

There is a strong consensus in Swedish society on equality as a major goal of society. This consensus is reflected by the fact that Sweden has one of the most equal distributions of income judged by most measures. Equality also concerns gender, i.e. women's position in society.

Being a small open economy, Sweden is exposed to tax competition from abroad. A number of steps have been taken after the financial deregulation in the 1980s and Swedish EU-membership to make Sweden attractive for inward-bound investment and to keep wealthy individuals and their ownership of Swedish business at home. As part of these policies to adapt to the new rules of globalization, the wealth tax, the inheritance tax and the gift tax were abolished in the past 10 years. In addition, the real estate tax was reduced significantly. These measures will eventually increase inequality. There are already clear signs of rising inequality as a new Swedish model is emerging, more capitalistic than the old one.

These developments imply challenges for the analysis of the Council. Which are the best policies and measures to combine equality and efficiency in an open, de-regulated and financially integrated economy without taxing wealth and the transfer of wealth between generations while maintaining a strong fiscal stance?

Another challenge for the Council is to evaluate the existing fiscal framework. Is this the proper one for Sweden? The present framework has evolved in response to the crisis of the early 1990s. But now, the Swedish economy has recovered and been on a stable growth path for almost two decades. There are thus good reasons to consider which fiscal framework will be the better one in the near future. In particular, the surplus target of 1 percent of GDP over the business cycle is a subject of contention.

5. The impact of the fiscal framework

As described above, Sweden has 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 per cent today (Chart 5). The trend seems to be towards still lower debt levels. The surplus target appears to have been met (Chart 8) and the 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. Rather, it is more complicated. The fiscal framework has evolved as part of a policy of fiscal stringency. The framework has been established to facilitate fiscal consolidation, by making it easier for the Government to argue for debt consolidation in spite of good times.[18] The political will to strengthen the fiscal stance has contributed to the fiscal consolidation and to the fiscal framework as well.

It seems that the most important building-block of the fiscal framework is 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 Minister 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 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.

It is too early to make any firm assessment of the impact of the Fiscal Policy Council, per se. It has only existed since 2007. It has produced five reports since then. They have met with considerable interest from the media and the public (Chart 14). Still, in some areas, an effect may be noticed. The dialogue where the Government responds in the budget of September on the report of the Council from May the same year is one channel of influence. The Government has responded to a number of the recommendations put forth by the Council. As

[18] 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).

the Council has established a credibility of its own and is supported by almost all the political parties, there are likely to be political costs for completely ignoring its views as argued above.

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 in the minds of present-day 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 for Portugal from Sweden

The record from Sweden suggests the following lessons for Portugal – to the best of my reading.[19]

1. Sweden adopted a fiscal framework including a fiscal policy council *after* the severe fiscal shock during the crisis in the early 1990s. The task of the framework including that of the Council should be to keep the memory of this shock alive in present and future fiscal policy debates. The fiscal framework should thus serve as an inoculation making the political system more resistant to fiscal profligacy and deficit financing. A similar pattern is emerging in Portugal today. A deep economic crisis contributes to the establishment of a fiscal policy council, although the process is driven to a large extent by external impulses.

2. In Sweden the fiscal consolidation process started *after* the financial and fiscal crisis of the 1990s and continued for many years. 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 although steps to put a fiscal framework and a fiscal council can be taken during the crisis when there is a sense of emergency in the political system.

3. The fiscal consolidation process in Sweden has been accompanied by falling long-term interest rates. Thus policy-makers have been rewarded by the financial market for their

[19] Lesson-learning is not an exact science. The views in this section are based on my own interpretation of the literature on fiscal councils.

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 of the Government. The Government's adherence to a fiscal framework will inform financial markets about fiscal developments. 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 given 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.[20]

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 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 is forced to decide on proper fiscal rules to use by itself, when judging the 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 council is facilitated by the council being at a distance from the Government. Independence is promoted by not being directly involved in policy-making, for example by supplying the ministry of finance with forecasts or other recommendations. By providing only *ex post* analysis of the Government's economic policy proposals and measures, a fiscal council can avoid being dragged directly into the policy process in a way that may jeopardize its independence.

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

[20] 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).

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.

9. A fiscal council can be a strong voice in the public debate, serving as an educator of the public and the political system on fiscal policy, 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.[21]

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 as in Sweden, such an environment probably makes a fiscal council more effective. These prerequisites concerning governance are not always available. In addition, they are difficult to establish in the short run. Although an open society with strong public trust in the political system and in the role of experts makes it easier for a fiscal policy council to have an impact, we should not expect the opposite to hold: 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. 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. We should not expect a new fiscal policy council to have an immediate impact regardless of where it is established. We should also expect that the new council being erected in Portugal will evolve over time in response to the challenges it faces.

7. Conclusions

The huge rise in government deficits and debt in recent years in many countries has created an interest in finding institutional arrangements to facilitate fiscal consolidation and keeping the rise in government expenditures at bay. Fiscal frameworks and fiscal policy councils are new steps in this direction, strongly promoted by the EU, the OECD and the IMF. They represent

[21] 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.

major policy innovations. They can play an important role by strengthening weak governance structures. This role is facilitated by a strong backing by the political system.

The fiscal experience of Sweden can serve as a source of inspiration for countries searching for new ways towards stable government finances. As a consequence of a deep budgetary crisis in the early 1990s, a fiscal framework including a fiscal policy council was constructed in a lengthy process in Sweden. This framework appears to be successful, at least so far.

Of course, the Swedish framework cannot be copied by other countries without paying attention to nation-specific institutional circumstances. Still, a number of lessons can be condensed from the Swedish experience. A basic one is that a fiscal framework is a method for constructing and maintaining a collective memory of the dangers of fiscal overexpansion. A fiscal council or independent fiscal authority 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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Table 1. Independent fiscal institutions as of early 2013

- Austria – Government Debt Committee
- Australia – Parliamentary Budget Officer (PBO)
- Belgium – High Council of Finance
- Canada – Parliamentary Budget Officer (PBO)
- Denmark – Economic Council
- Finland – Fiscal Policy Audit and Executive Office (in the National Audit Office of Finland)
- France – *Haut Conseil des finances publiques*
- Ireland – Fiscal Advisory Council
- Korea – National Assembly Budget Office (NABO)
- Mexico – Centro de Estudios de las Finanzas Públicas (CEFP)
- The Netherlands – Bureau for Economic Policy Analysis (CPB)
- Portugal – Council on Public Finances (CFP)
- Slovak Republic – Council for Budget Responsibility
- Slovenia – Fiscal Council
- Sweden – Fiscal Policy Council (FPC)
- United Kingdom – Office for Budget Responsibility (OBR)
- United States – Congressional Budget Office (CBO)

Source: OECD

Table 2. Macroeconomic indicators for Portugal and Sweden 2012

	Portugal	**Sweden**
Population (millions)	10.7	9.5
GDP (millions euro)	166.3	411.0
GDP per capita (thousand euro)	15.6	43.2
GDP per capita adjusted for purchasing power (PPS)	18.5	33.4
GDP growth 2000-2012 (average annual %)	2.7	4.4
GDP growth 2008-2012 (average annual %)	-0.3	4.6
Inflation rate 2000-2012 (average annual %)	2.6	1.8
Inflation rate 2008-2012 (average annual %)	1.9	1.9
Nominal long-term interest rates on government debt (%)	11.4	1.6
Unemployment (%)	15.5	7.5
Exports of goods and services (% of GDP)	38.6	48.9
Current account balance (% of GDP)	-3.0	6.4
Government consolidated gross debt (% of GDP)	119.1	37.4
Government net lending/borrowing (% of GDP)	-5.0	-0.2
Government revenue (% of GDP)	41.7	51.4
Government expenditure (% of GDP)	46.7	51.6

Sources: AMECO and OECD

Note: The purchasing power adjusted data for GPD is taken from EU Purchasing Power Standard Units (PPS).

Table 3. Trust in political parties, the government and the parliament and satisfaction with the way democracy works in Portugal and Sweden in the fall of 2012, per cent of respondents.

	Portugal			Sweden		
	Tend to trust	***Tend not to trust***	***Don't know***	***Tend to trust***	***Tend not to trust***	***Don't know***
Political parties	17	79	4	35	61	4
The Government	22	74	4	59	38	3
The Parliament	23	73	4	68	29	3
	Very/ Fairly	***Not very/ Not at all***	***Don't know***	***Very/ Fairly***	***Not very/ Not at all***	***Don't know***
Satisfaction with the way democracy works	25	74	1	86	13	1

Source: European Commission, Eurobarometer 78

Table 4. Governance indicators [min -2.5 max 2.5] for Portugal and Sweden

	Portugal	Sweden
Government effectiveness	1.0	2.0
Voice and accountability	1.1	1.6
Regulatory quality	0.7	1.8
Rule of law	1.0	1.9
Control of corruption	1.1	2.2
Do you have confidence in the national government? (% yes)	24.6	67.2
Do you think that most people can be trusted? (% yes)	27.9	56.1

Source: The World Bank Governance Indicators and the 2012 Legatum Prosperity Index

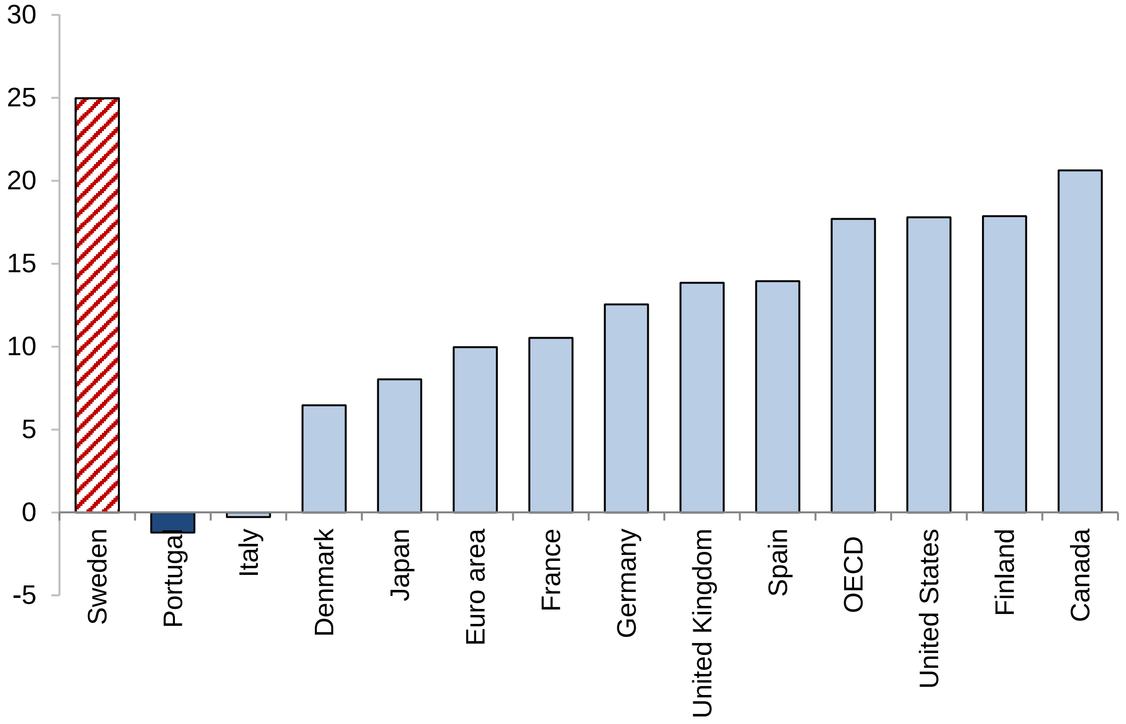
Note:

Government effectiveness	Reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
Voice and accountability	Reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.
Regulatory quality	Reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
Rule of law	Reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.
Control of corruption	Reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

Table 5. The evolution of the Swedish fiscal framework 1995-2007

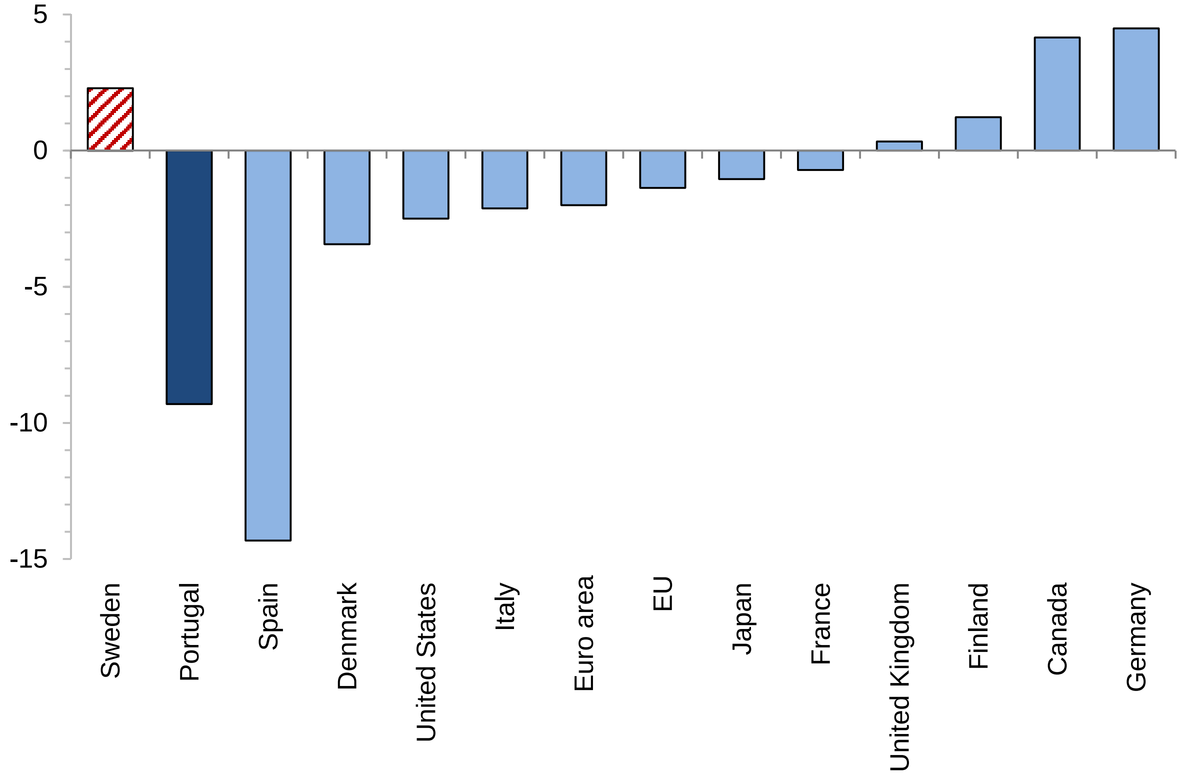
Since 1995: *Top-down approach* for the central government budget.
Since 2000: *Surplus target* General government net lending is required to show a surplus of 1 per cent over the course of a business cycle. A buffer for economic fluctuations and demographic changes.
Since 1997: *Central government expenditure 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*.

Chart 1. Total real GDP growth (%) in selected countries, 2002-2012



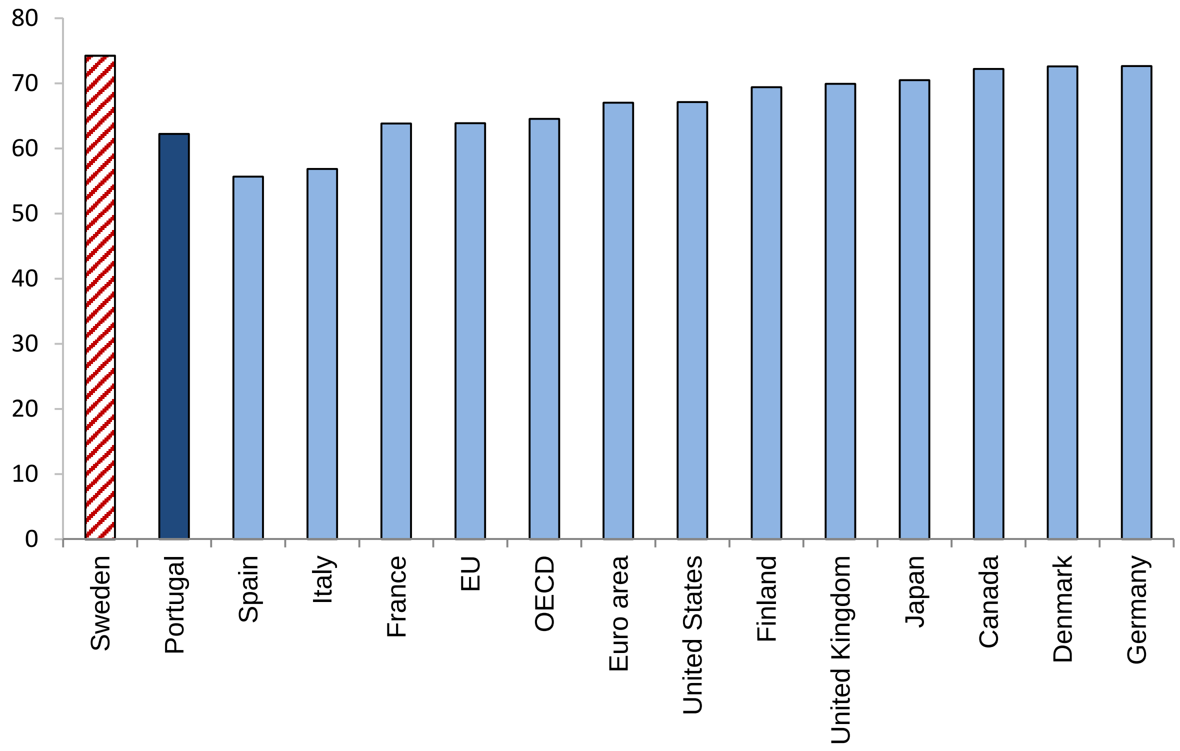
Source: OECD

Chart 2. Employment growth (%) in selected countries, 2007-2012



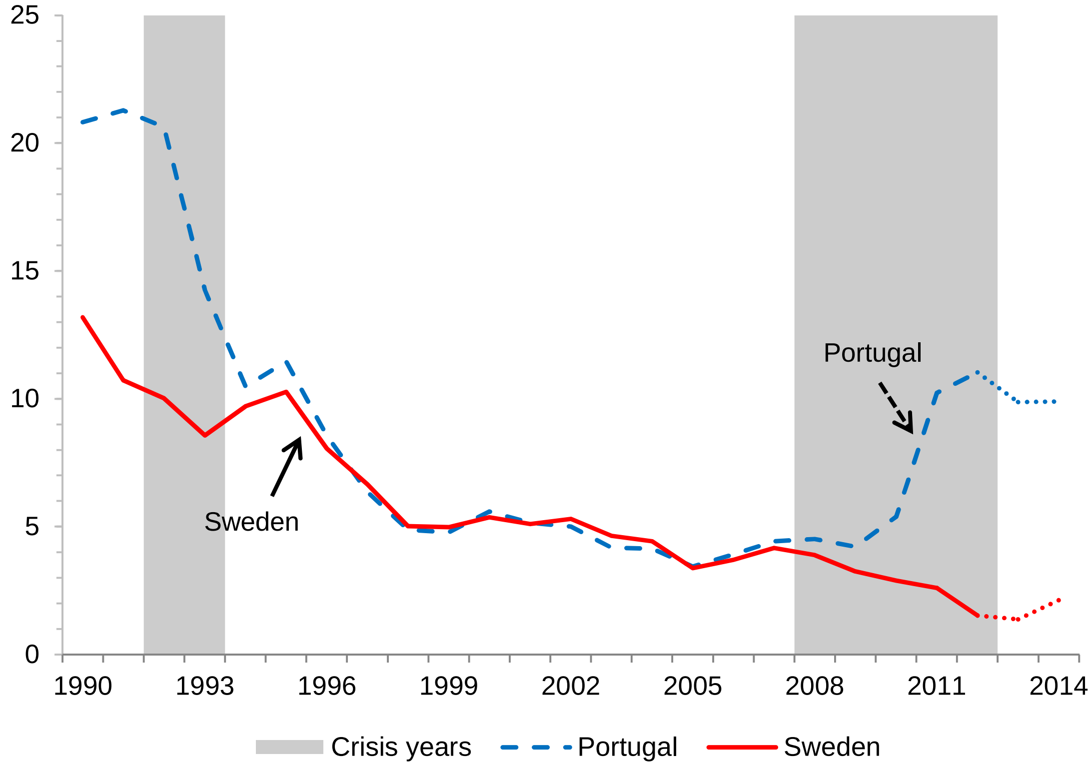
Source: AMECO

Chart 3. Employment rate, 15-64 years (%) in selected countries 2012



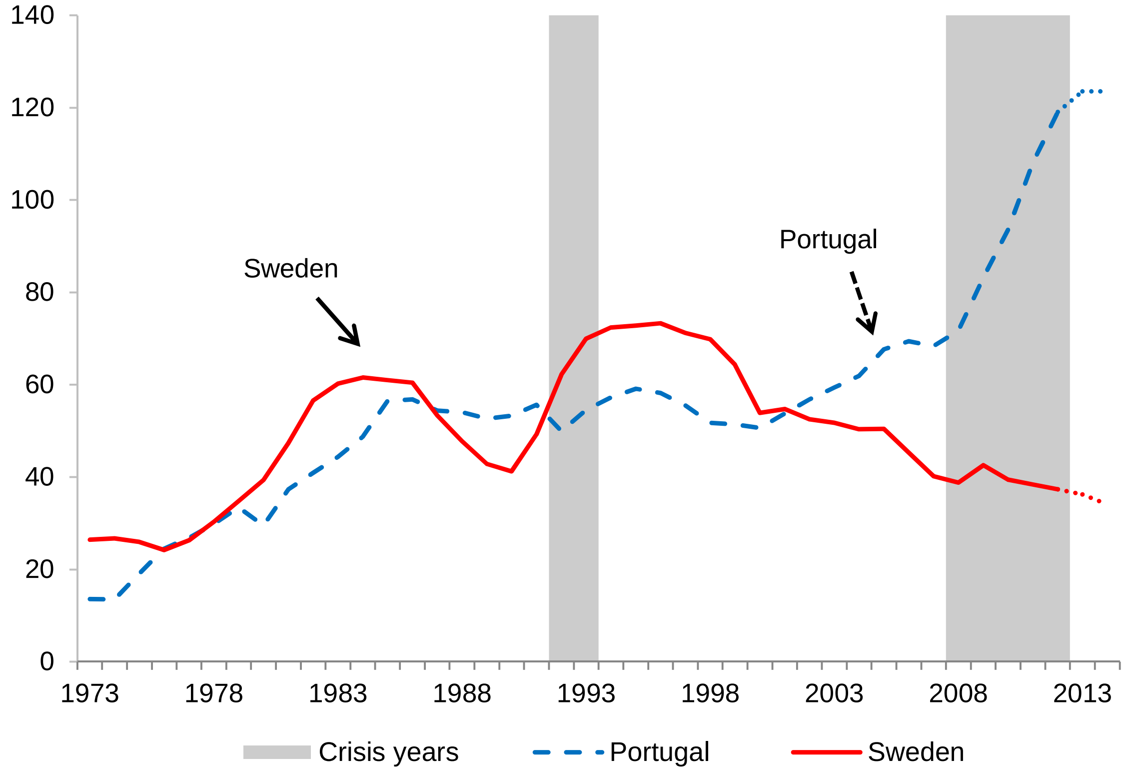
Source: OECD

Chart 4. Long-term interest rate on government bonds for Portugal and Sweden, 1990-2014, per cent



Source: OECD

Chart 5. Government gross debt (% of GDP) for Portugal and Sweden, 1973-2014



Source: AMECO

Chart 6. General government net lending (% of GDP) for EU-members 2013

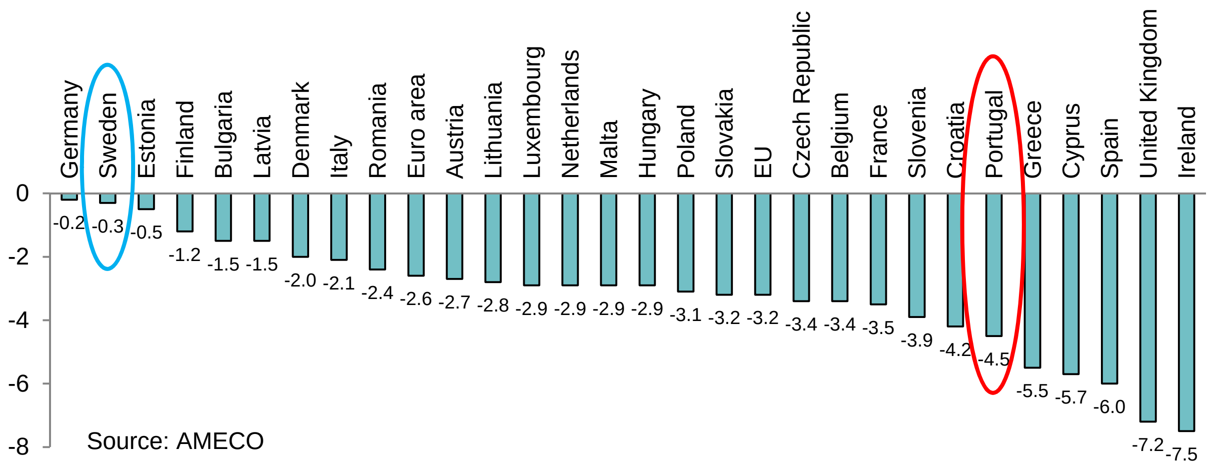
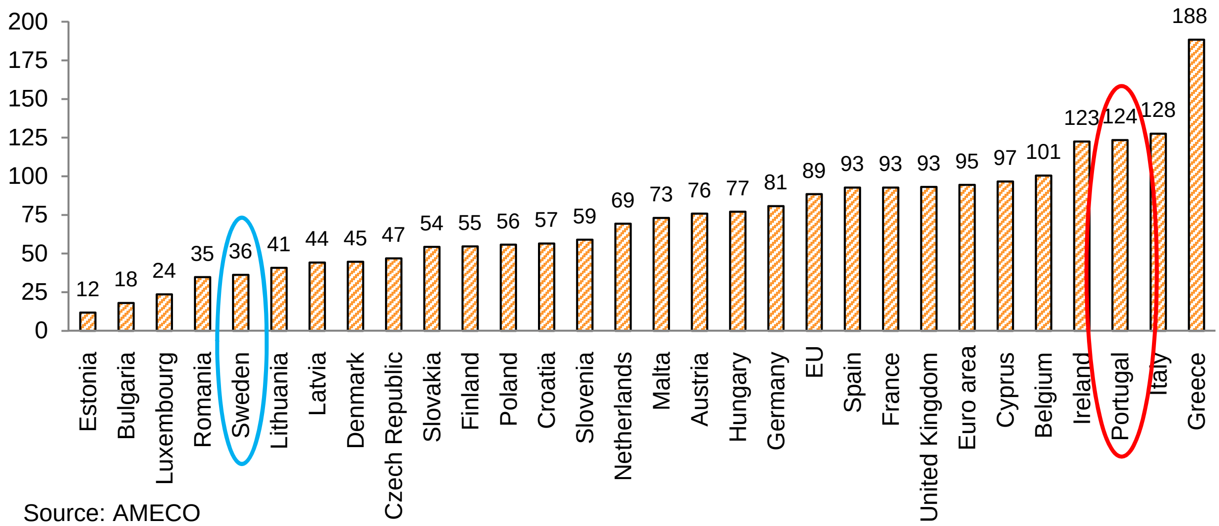
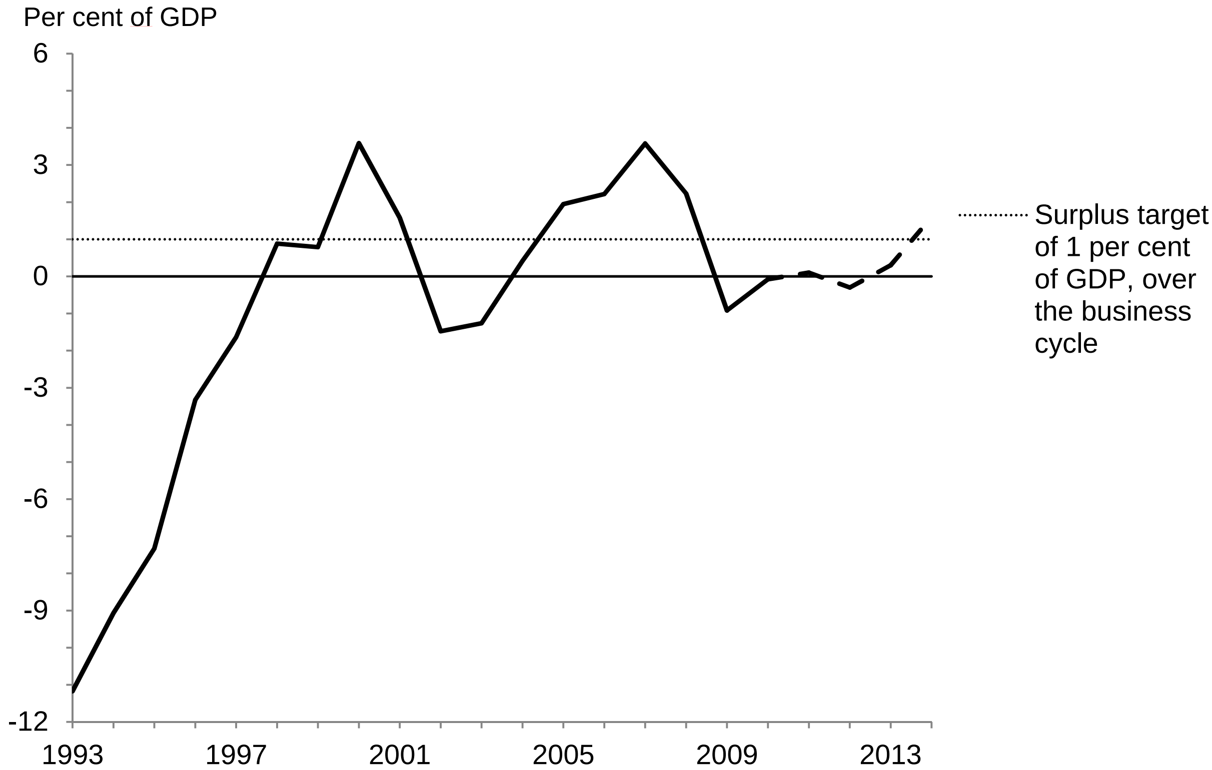


Chart 7. General government gross debt (% of GDP) for EU-members 2013



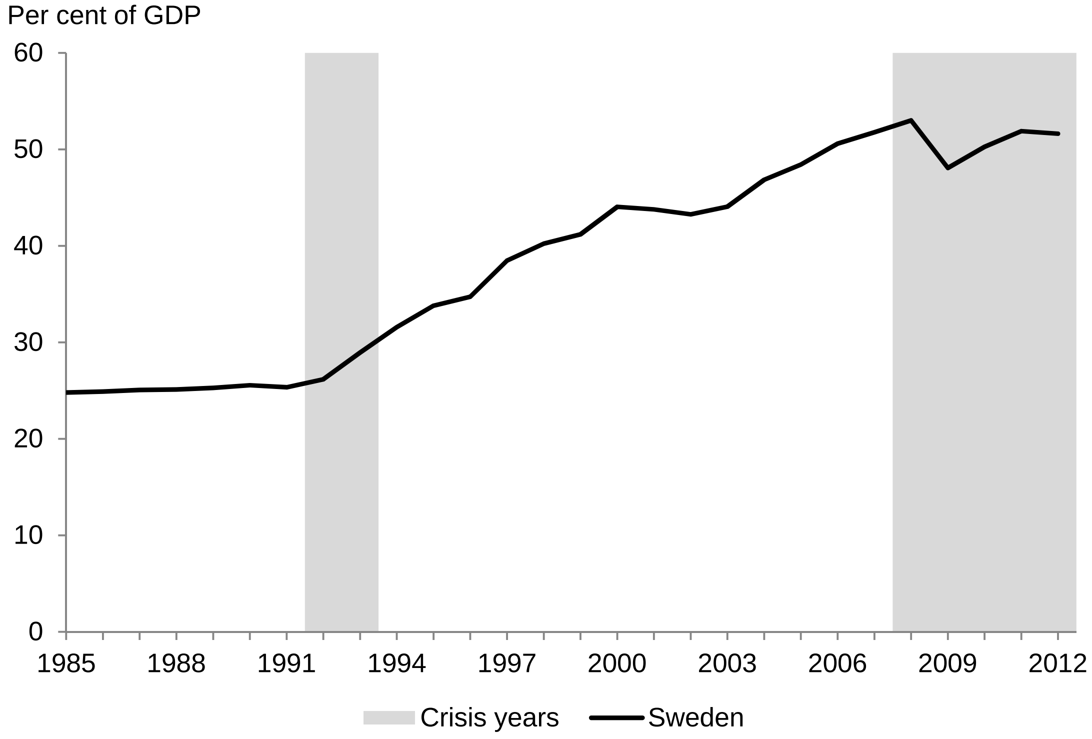
Source: AMECO

Chart 8. General government net lending in Sweden (% of GDP), 1993-2014



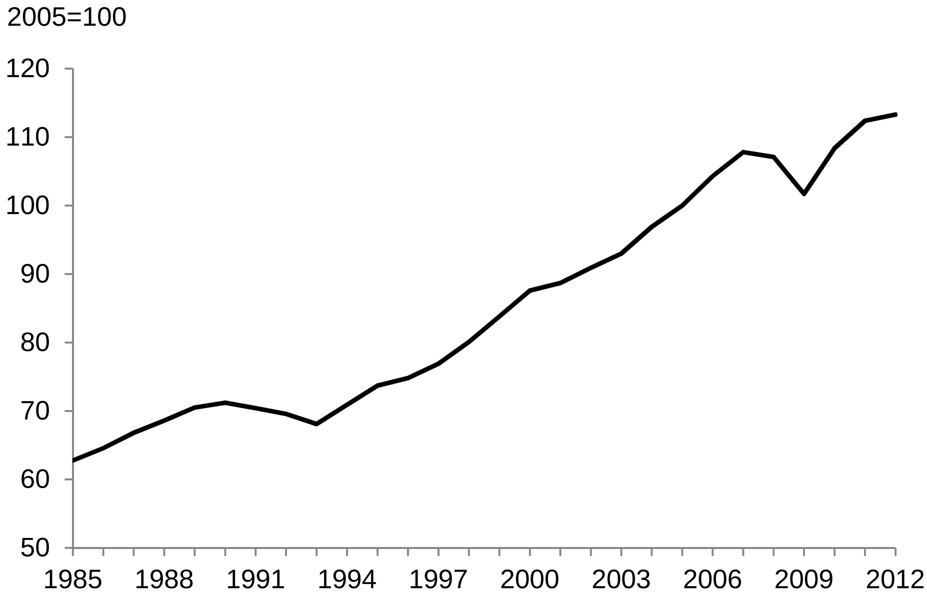
Source: AMECO

Chart 9. Export of goods and services (% of GDP, constant prices) 1985-2012



Source: AMECO

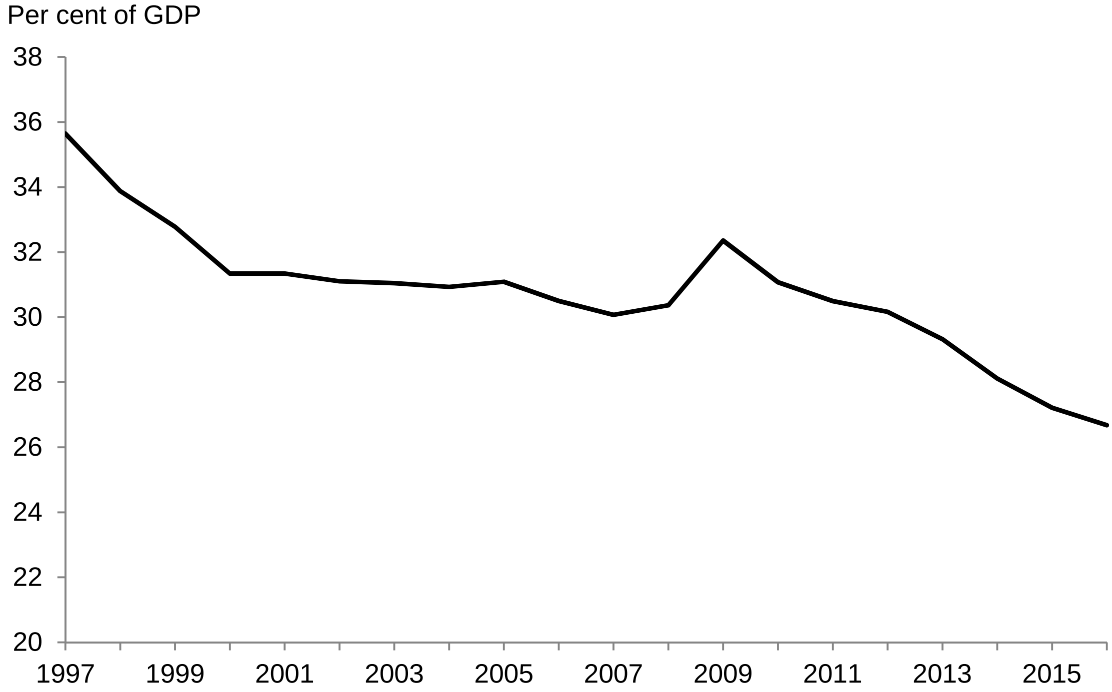
Chart 10. Economic growth in Sweden 1985-2012



Note: Index of GDP at constant prices, with base year 2005.

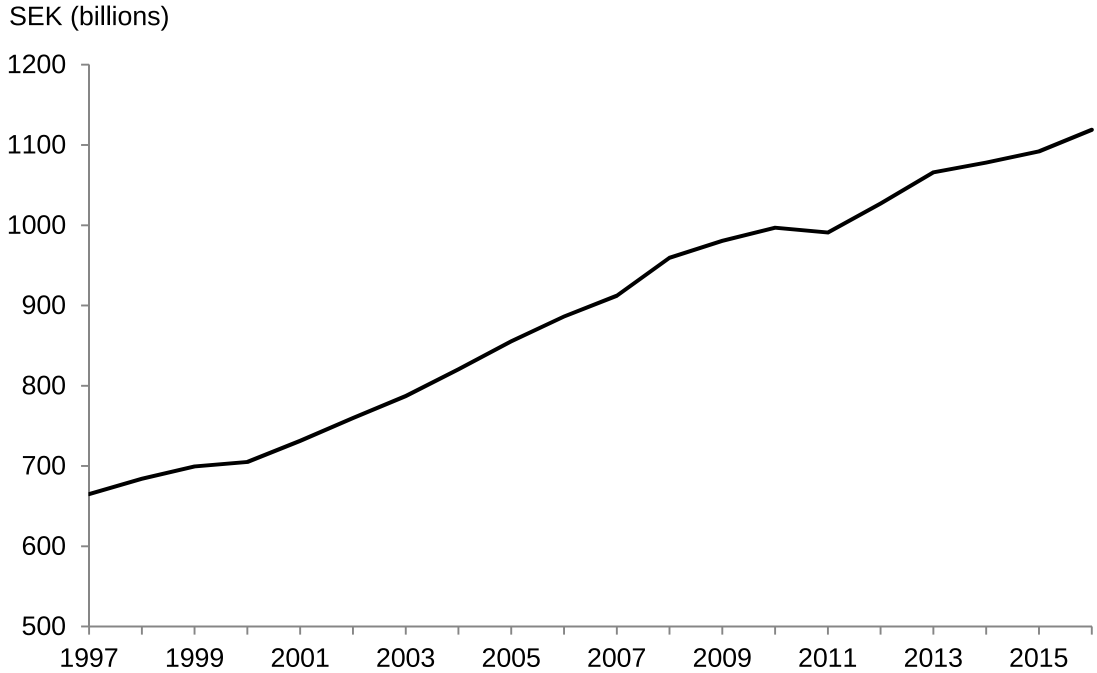
Source: Statistics Sweden

Chart 11. The expenditure ceiling as a percentage of GDP, 1997-2015



Source: The Swedish Ministry of Finance

Chart 12. Government expenditure in billions of SEK



Source: The Swedish Ministry of Finance

Chart 13. The institutional set-up for the Swedish Fiscal Policy Council

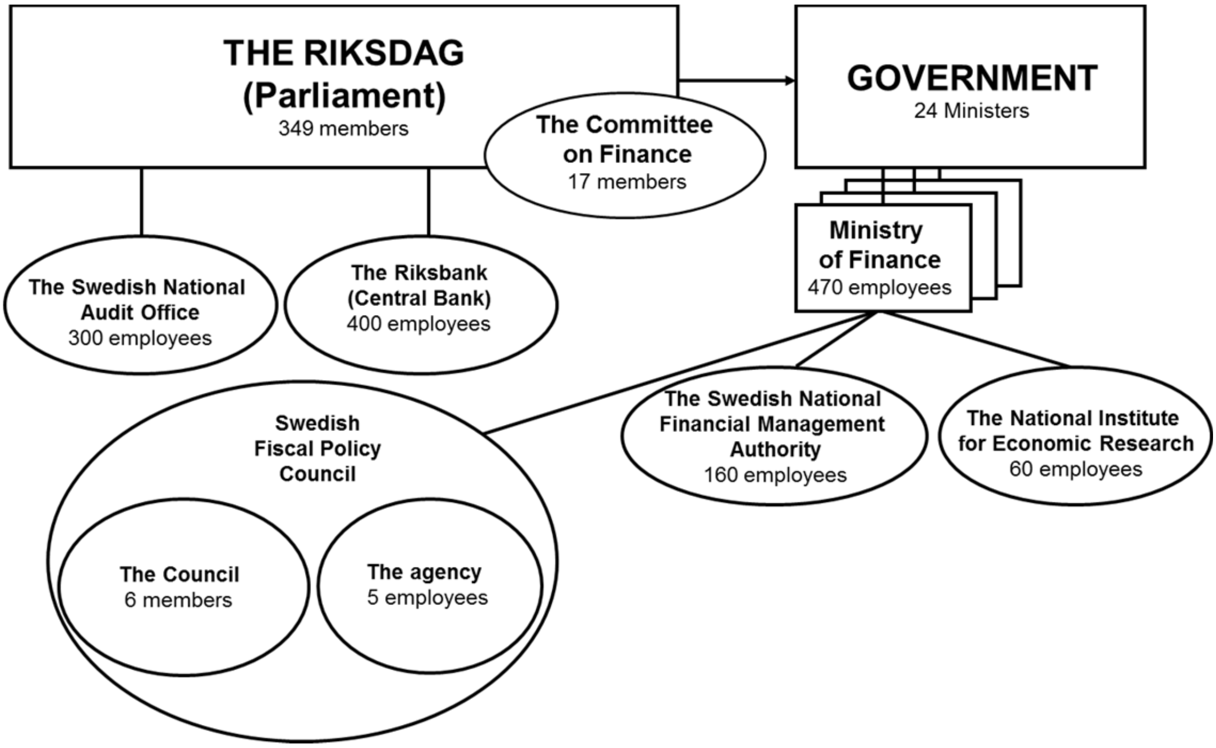
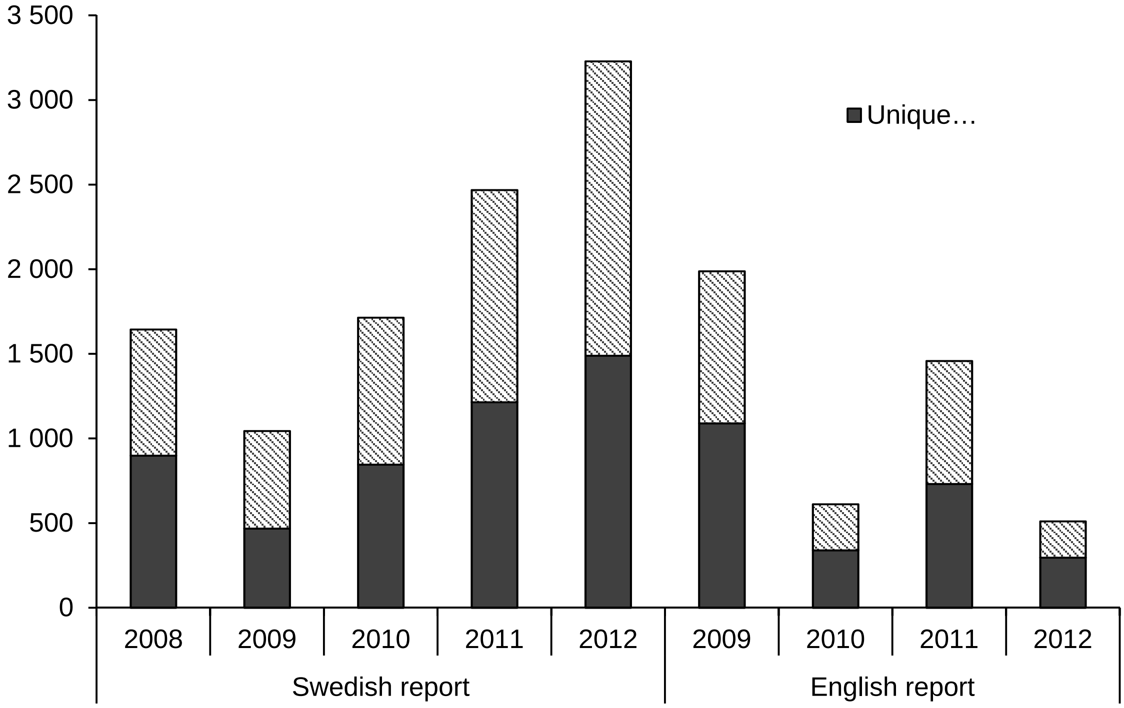


Chart 14. The number of downloads of the annual report of the Swedish Fiscal Policy Council, 2008-2012



Note: Unique downloads are defined as the number of downloads from unique IP-addresses, i.e. excluding multiple downloads from the same visitor.