REGERINGSKANSLIET

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Ministry of Finance
Sweden

The Swedish model for sustainable public finances

Sehr geehrte Damen und Herren, liebe Kollegen,

vielen Dank für Ihre freundliche Einladung!

Es ist mir eine Freude von den schwedischen Erfahrungen beim Abbau der hohen Staatsverschuldung - von den neunziger Jahren bis heute - zu sprechen.

Aber zuerst möchte ich Ihnen sagen, dass es für mich persönlich immer wieder sehr schön ist nach Wien zu kommen. In 1992 und 1994 habe ich in Wien studiert. An der Wirtschaftsuni und am Institut für Höhere Studien studiert. Angesichts der großen Ökonomen, die Österreich hervorgebracht hat, war dies ein besonderes Erlebnis. Ich hab fleissig studiert – aber auch sehr viel Spass gehabt. Ich bin seitdem often nach Österreich zurückgekommen. Aber natürlich konnte ich vor 22 Jahren nicht vorstellen, dass ich eines Tages als schwedische Finanzministerin nach Wien kommen würde.

Österreich ist eines der wohlhabendsten Länder in der EU. Österreich hat eine starke soziale und wirtschaftliche Stellung. Es ist offensichtlich, dass Österreich einiges richtig macht!

Es würde mich natürlich dennoch sehr freuen, wenn die schwedischen Erfahrungen aus dem Bereich der Fiskalpolitik Ihr Interesse finden.

Ich gehe jetzt weiter auf englisch.

Today we see worrying tendencies towards beliefs in simplified solutions, in Europe and elsewhere. Quick fixes and promises without substance – it is getting more difficult for responsible politicians, who are ready to face the real world. Of course, we need visions! I did not join the social democratic party some 25 years ago because of my deep conviction of sound public finances. I wanted to save the world, like many of us - I still do. But one crucial thing has changed. With age and experiences comes the insight that the world cannot be saved without responsible use of our common resources. There are three main reasons for this.

Number one. Too often we hear of a false contradiction between sound public finances on the one hand and growth, employment and welfare on the other hand. I do not agree with that. Sound public finances are a

prerequisite for growth, employment and welfare. Sustainable welfare must be built on a solid foundation. Investments are not drawn to countries with unstable macroeconomics.
Austerity is therefore a necessary evil. Or maybe – even a friend.

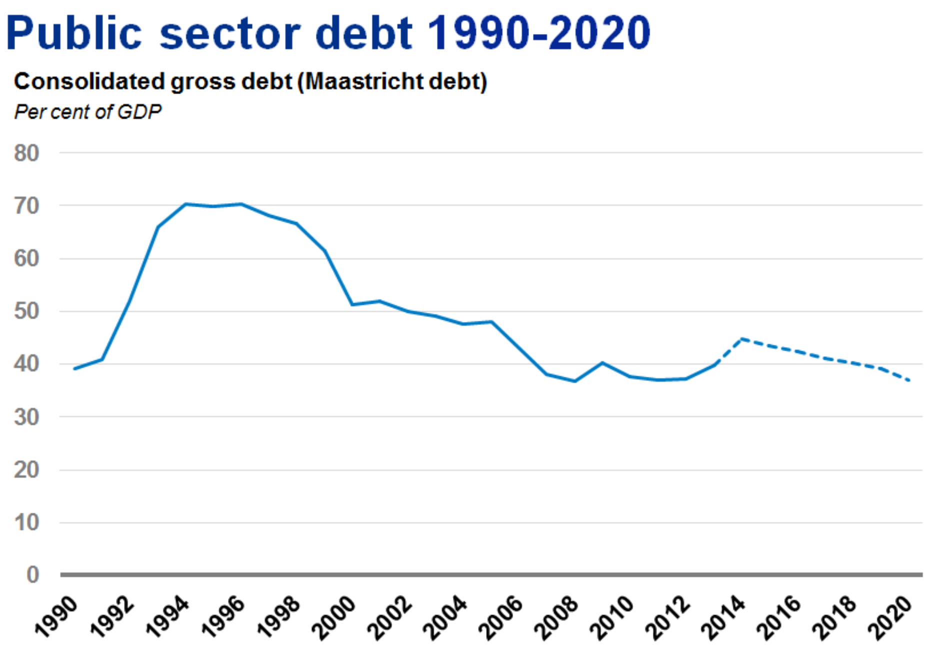
Second reason - sound public finances are key to the implicit social contracts between citizens and the public sector, on which the willingness to pay relatively high taxes is dependent. This is particularly the case in Sweden, but also in Austria, I think, where public policy has a profound influence on the citizen's everyday life. If there is uncertainty about the government's ability to handle fiscal policy in a welfare state, the social contract between the public sector and the citizen will be in danger.

It is an often-repeated joke in political science that an implicit contract is not worth the paper it is written on. The empirical evidence of this could of course be described as mixed. But we are fortunate to live in a part of the world where this social contract has held up well.

My third reason, when governments are forced to rapidly consolidate, especially when welfare systems are cut back, it will hurt the people that are most dependant on the public sector. This is obviously not a situation where any government wants to find itself. But the alternative would, in some cases, be a vicious cycle that would put society in a far worse position. All governments who claim to defend a high quality welfare level have no other option than to keep the public finances in check. Thus, for any political movement with a strong social agenda, sound public finances must be at the centre. Sweden, and the social democrats, has learned this the hard way.

For that reason, I am honoured to be invited to speak about this pressing matter for you today.

Graph 1. Public sector consolidated gross debt to GDP (Maastricht debt)



(Swedish background)

So let me show you this graph of the public debt in Sweden the last 25 years and a projection for the next five years. In 1991 Sweden found itself in the eye of a severe banking crisis. GDP fell for three consecutive years and unemployment rose to ten per cent. This had, as you can see, consequences for the debt level which rose by more than 30 percent of GDP in three years. The public finances dropped from plus 3 per cent of GDP to minus 11 percent. The crisis had severe effects on the economy and carried large costs for many individuals.

This serious situation triggered a substantial consolidation programme amounting to 8 per cent of GDP. The programme was initiated in 1994 by the newly elected social democratic government. I was part of the team that set up the program during the election campaign and after elections I was appointed Political Advisor at the Prime Minister's Office.

The programme was equally divided in reduced expenditures and higher revenues, and had three main properties; (i) most measures came early on (frontloading), (ii) everyone and every part of society had to contribute (iii) Public services like schools and health care were given priority relative to social transfers. The argument being that giving our children bad schooling has worse long-term effects than cutting unemployment insurance or pensions.

During the same period other reforms were implemented. The fixed exchange rate regime for the Swedish krona came to an end and we implemented the independent central bank reform. The Swedish pension system was substantially reformed and, not least, the budget and fiscal policy processes was changed. As you can see from the graph, the debt level has been on a downward trend since then.

(Reformation of the Swedish budget process)

Up until the early 1990s, budget policy in Sweden lacked clear rules and goals and the budget process was considerably less stringent than it is today. As a result, short-term considerations carried great weight at the expense of long-term sustainability. The lesson from the crisis was that the political decision-making process needed a credible set of rules to reduce the risk of recurrent deficits.

A fundamental idea was to give the budget process a clear top down design. The total of expenditure could not be determined by summing up the various preferences, but must be based on a comprehensive economic assessment. To achieve this, a number of quantitative targets and restrictions were introduced.

(The Fiscal Policy Framework)

So what are the four cornerstones of the Swedish framework?

Graph 2. Four corner stones of the fiscal policy framework

Fiscal Targets

- **Surplus target:** surplus in general government 1 per cent of GDP on average over the cycle
- **Expenditure ceiling:** nominal maximum for central government expenditures decided 3 years in advance
- **Balanced budget requirement:** Local governments are not allowed to borrow for consumption
- A strict **top-down budget process** at the ministries and in Parliament

(Surplus target)

Well, first of all, the primary fiscal target for the Government is to achieve a surplus in the general government finances amounting to 1 percent of GDP over the business cycle. This surplus target was introduced in the late 1990ies by the social democratic Government. Disputed at first, it was later accepted by the centre-right Government. Aiming for a surplus in normal times has brought the debt level down and prepared us for the time which has now come when public sector expenditure tends to increase for demographic reasons.

(The Expenditure Ceiling)

The expenditure ceiling was introduced in 1997 as a means to achieve the surplus target and induce increased cost control. It sets the maximum government expenditures for the coming three years. If the ceiling is threatened by increasing expenditures, the Budget act forces the

Government to propose measures to prevent this. For instance, we did this during the refugee crisis last year.

One of the ceiling's primary functions is to provide a desirable long-term development of government expenditures. Once it has been set there is a political price to change it. The margin between the expenditures and the ceiling has been small at times.

But – and this is the good part - every government since the fiscal framework came in to place, has respected the expenditure ceiling. And I am definitely not going to be the Minister of Finance in Sweden who breaks this great track record.

(Balanced-budget requirements)

Moving on, we also have a balanced-budget requirement, for the nearly 300 local governments in Sweden. They have a high degree of independence and are allowed to decide on their own tax rates. However, they are not allowed to prepare a budget where their income does not cover their operating costs. If a local government ends up with a deficit anyway; it has to make up for it within three years. The requirement has had clear effects on local governments' results that have gone from large deficits to surpluses.

(A Top-down Budget Process)

My minister colleagues in the government are all very ambitious people, trust me. I believe the same is true for Austria. That's something to be very grateful for – of course. But when it comes to the budget negotiations, their ambitions often vastly exceeds the fiscal space decided by the targets. The top-down perspective then sets clear limits for new reforms, which paves the way for sustainable public finances.

The same principles have then been applied to the decision process in parliament. Particularly important in Sweden where we have a tradition of minority governments.

(**A surplus biased budget**)

An important feature of a well-designed and sustainable budget process is to avoid automatic indexing of expenditures. Elected politicians should be able to set priorities in the annual budget, and not have one hand tied behind the back by previous decided indexing.

Without active fiscal decisions, an automatic surplus is generated in the Swedish budget. The reason for this is quite simple; the Swedish tax system is mostly indexed to growth. Tax income therefore grows at about the same pace as GDP. Public expenditure, however, grows slower than GDP if rules are unchanged. The general governments net lending will therefore normally improve by 0.3–0.5 per cent of GDP annually. So with a wisely designed budget, you gain an automatic strengthening of public finances. This is really a Minister of Finances' best friend!

So, where does the Swedish fiscal framework need to go from here, one can ask? Even if the main elements of the current fiscal framework go back to the crisis of the early 1990ies, the framework has evolved over time.

Recently, a comprehensive review was finalized by a committee comprising all parties in Parliament. It was agreed that the surplus target should be lowered to one third of a percent of GDP, from today's level at one percent of GDP. The main arguments for lowering the surplus target is that public debt is much lower than in the 90s and that public expenditure will likely increase for demographic reasons in Sweden.

This new level of the surplus target will still lead to a further drop in the debt level, but at a slower pace than before.
The agreement also stipulated that a reference value for the public sector debt will be introduced, a debt anchor, at 35 percent of GDP.

I am very glad that such a broad majority – 86 per cent of the Parliament stand behind these changes. In the Swedish context – this is an historical agreement.

(A European perspective)

Let me now take a European perspective. For a long time, Sweden has seen the EU fiscal targets as an expression of sound economic policies, not as an unwelcome constraint. We have always wanted to over-comply and keep a safety margin to the targets in the Stability and Growth Pact. Sweden is one out of only three Member States that never has been in the so called excessive deficit procedure since the start of the euro.

We are deeply worried about the disrespect for the rules in the Stability and Growth Pact. The tendency to make the rules more and more flexible and to create additional loopholes is a cause of concern. We have endless EU discussions among ministers and technical experts on creative accounting, on extra time for complying, on bending the rules in ever more inventive ways. The countries which are fighting hardest for changes in this direction, do they have the best growth and employment record? No, they certainly do not. Deficit and debt is not the road to sustainable growth and employment.

The euro would be a stronger project with sounder public finances. The disregard for the rules is really hurting Europe. One effect is that there is less room – or no room – to use fiscal policy in a downturn. When the next crisis comes – and it will come – the Eurozone is more vulnerable. This is hurting the weakest in society. Basically, it is for each Member State do to its home work. There are no shortcuts. Weakening the

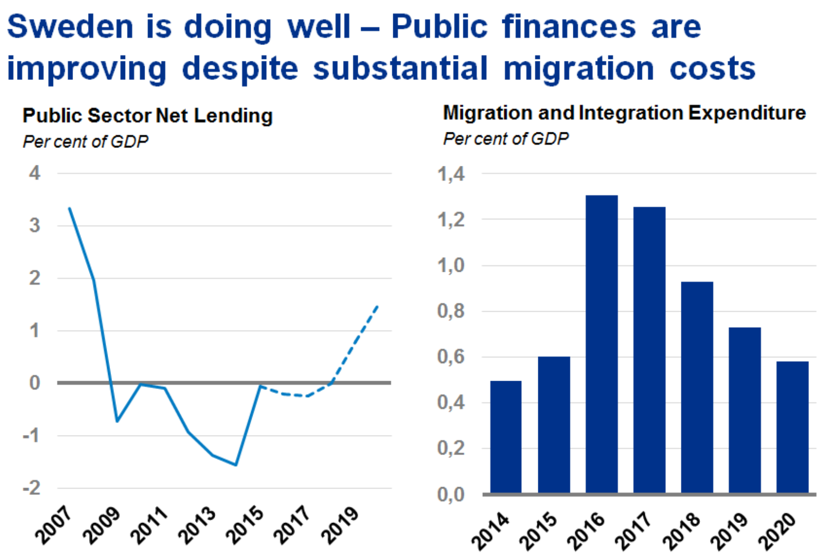
Growth and Stability Pact is not a shortcut. A fiscal capacity for the Eurozone is not a shortcut.

We have at the moment a lot of discussion on new schemes to reform EMU. A fiscal capacity or a Eurozone finance minister, for instance. I will not discuss these proposals at length, but only point out that we already have a strong fiscal framework in the EU. Let us first use what we already have, before we set up new, far-reaching initiatives.

I understand that change cannot happen from one day to the other. But if there are more Member States who act as guardians for sound public finances, we raise the chances for a stronger EMU and EU. I am glad to note the ambitions of Austria in this regard.

(Present situation in Sweden)

Graph 3. Sweden is doing well



Over the last years, the Swedish economy has developed well.. Swedish growth is high in an international perspective and will continue to be among the highest in the European Union in 2017. Unemployment is falling fast, but remains a challenge. But the employment rate is very high - actually the highest ever measured in the EU. Not at least thanks to high labor force participation for women.

We have a tight fiscal policy and a deficit of almost two percent that I inherited when I took office two years ago was essentially wiped within a year. This was done despite the strain on the public finances of the large number of asylum seekers last autumn.

Sweden will continue to be a well-developed welfare state of high quality that can be trusted. Therefore, my government has made major investments in health, education and welfare. When the population of Sweden is growing, this is particularly important.

(Summing up)

We know from experience that a fiscal crisis comes at a high price. It will most often have long lasting negative effects on GDP growth and employment. In a crisis, power is shifted from politicians to the markets and creditors, and focus has to be shifted from constructive policy ideas to crisis management. This is a situation which we want to stay away from. Far away!

The Swedish experience shows the need of clear rules for fiscal policy making. But importantly, this view has wide support in the general public in Sweden. It is difficult or even impossible in Swedish politics to win elections on irresponsible fiscal policies. Sound public finances are for Swedes like the great Austrian Alps - it's a very hard thing to go around.

The public debt has been brought down and we are now better prepared to meet the challenges of an ageing population or a severe economic down- turn. Perhaps you can see this as an insurance premium. Rules which entail hard targets and restrictions sometimes come at a cost, but in the long run I am convinced that it is worth paying the fee.

Thank you for your attention.