Conference: "The Swiss Debt Brake - Ten Years on". Panel 1: some notes on the Swedish experience

> ***Question 1**: On theoretical grounds, public debt may be used to enhance welfare but it may also be abused, in particular in the presence of political frictions. Which of the theoretical roles for debt --- welfare enhancing or not --- have been particularly relevant in your view?*

Answer:

- My comments take the point of view of a decision maker:

- Government debt can help people to smooth consumption when facing uninsurable risk. The possibility/option to accumulate debt is an <u>insurance mechanism</u>;

- To maintain the ability to run a deficit and accumulate debt, <u>without running the risk of being punished by financial markets</u>, is of fundamental political and economic value for any government;

- An emphasis on the importance of freedom of action – or *discretion* as an economist would put it – has been at the core of Swedish fiscal policy since the middle of the 1990s;

- "Those who are in debt are not free", Göran Persson, Minister for Finance, 1995;

- "We **can now use our strength**, with Swedish public finances being among the strongest in the EU, **to invest in the future/…/**The budget for 2013 means that we can be expansive, but still have **safety margins** in case of a severe economic slowdown." Anders Borg, Minister for Finance;

- The precautionary motive is emphasized in Swedish politics: In order to have room for maneuver, the policy of the government is to keep debt low.

Question 2: *Institutional constraints on public debt or deficits typically intend to mitigate the consequences of political frictions. To what extent have institutional constraints in place achieved this goal? And to what extent have they undermined possibilities to use public debt in welfare enhancing ways? Where have institutional constraints successfully achieved a balance between mitigating the consequences of political frictions on the one hand and allowing for welfare enhancing debt policies on the other?*

Answer:

The Swedish Fiscal Framework:

- Top-down budget process;
- A fiscal *surplus target* for general government net lending of 1% of GDP, on average, over the business-cycle;
- Central government *expenditure ceiling* set 3 years in advance;
- Balanced budget requirement for local governments;
- Since 2007, a Fiscal Policy Council with a broad remit (to facilitate transparency and accountability).

Has the fiscal policy framework worked?

- Generally successful implementation:
  - Top-down approach is followed;
  - Spending ceilings have not been breached (albeit some minor, and politically costly, examples of creative bookkeeping);
  - Surplus target has been met – at least until now… (various indicators used);
  - Broad political support: opposition wanted more spending during crisis, but less than 1% of GDP;
  - The Fiscal Policy Council has increased the transparency and facilitated a higher quality of the political discussion.

To what extent has the framework undermined possibilities to use public debt in welfare enhancing ways?

- A counterfactual verdict: The framework has <u>not hampered</u> policy in any detrimental way, at least not so far…

Question 3: *Many institutional constraints apply selectively, for example only at the level of central government or only with respect to explicit debt. Should the scope of such institutional constraints be broadened, for example to the subnational level or to implicit debt (e.g., social security systems)? What problems could arise in the process?*

Answer:

- A new pension system was introduced in the aftermath of the fiscal crisis in Sweden in the 1990s. The reform made the system more robust to population aging, added flexibility about the pension age, and strengthened individual incentives to postpone retirement;

- The increased robustness was achieved by restricting pension benefits to the resources in the system; that was basically done by changing from a defined benefits system to a contributions-defined system. This system is robust to variations in growth and demographics;

- The system is by design financially stable: benefit payments from the system are automatically adjusted to match changed contributions to the system;

- The system implies that pensions will fall relative to incomes as the population ages;

- The properties of this system explain to a great extent the long-term stability of Swedish public finances (e.g. EU COM S2-indicator);

- But is this system politically stable? That's an open question…

Question 4: *Institutional constraints on public debt or deficits can only be effective if it is difficult to undo them. But how can democratic societies succeed in tying their own hands? Can institutional constraints only work if rational and forward looking voters guard them (and what's their role then, anyway)? Or if international agreements secure them?*

Answer:

- The establishment of the new fiscal framework in the latter half of the 1990s was a response to the fiscal crisis in 1991-1993;
- A broad political *and* popular support for reform was a necessary precondition for budget consolidation and reforms. A political *story* was needed;
- "Someone" else is not going to pay ("*Those who are in debt are not free*");
- This created a consensus on the merits of a fiscal norm as a way of reducing the risk of new such crises. This norm is still very much alive. The opposition recently criticized the government for being <u>too expansive</u> in its last budget bill (the difference was 5 billion SEK…), and thereby threatening the long-term sustainability of the public finances ;
- Institutional reforms pegged down and enhanced institutional memory. The *Fiscal Council* monitors the fiscal policy and evaluates whether the government meets its objectives and respects the fiscal framework created during the 1990s;
- The Swedish system includes a high degree of transparency, which provides the basis for a well-informed policy debate, thus <u>raising the reputation costs</u> for the government of deviating from its targets. The most important role for the *Fiscal Council* is to contribute to this policy debate;
- I don't think that international agreements secure institutional constraints on public debt or deficits. What happened to the *Stability and Growth Pact* in 2005 illustrates this fact. The revision of the pact followed, as you know, upon violations of the fiscal rules by France and Germany. You must build domestic support for any institutional set-up in order to maintain popular support for fiscal rules to secure enough support for them when times get tough.