Getting fiscal consolidation right: lessons from Sweden

by

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Introduction

It is a pleasure to be here at the London School of Economics this evening, to speak at one of the world's most prestigious and respected academic institutions.

The title of this evening's lecture is "Getting fiscal consolidation right: lessons from Sweden." My intention is to contribute to the discussion concerning the fiscal consolidation facing the UK and many other OECD countries, by sharing some lessons from the Swedish experience of dealing successfully with fiscal deficits and mounting debt in the 1990s.

I will also highlight some cornerstones that are fundamental in our current economic policy and that have helped us through the financial crisis without ruining public finances. Key elements here include our policies for safeguarding labour force participation, our reforms of benefits systems, and our tax reforms. These reforms have been crucial in dealing with the underlying structural problems in the Swedish economy, which the consolidation of the 1990s did not address. Most importantly, they have allowed us to pursue an expansionary fiscal policy, manage the economic crisis, and maintain order and stability in the economy, all while avoiding large deficits.

Sweden was hit by a deep recession in 1990-93, as GDP fell three years in a row, employment declined by 11 percent and unemployment quadrupled to 8 percent. Public finances suffered greatly, with deficits at around 10 percent for several years, and the debt growing from around 45 percent to nearly 80 percent of GDP.

Today public finances are again under threat, but this time in many different countries, as a result of **the worst economic crisis since the 1930s**. One year ago we

stood on the brink of catastrophe. The collapse of Lehman Brothers sent shockwaves through the financial system. Credit markets and interbank lending dried up, world trade plummeted, and we feared the onset of another Depression, with years of negative growth and a possible implosion of the financial system. In this context, it was necessary and justified to pursue heavily expansionary fiscal policies throughout the world – and it will be necessary to continue doing so throughout 2010.

While a depression has been avoided, we are still going through some tough times. EU GDP has fallen by five percent in the past year. Unemployment across Europe has increased by over five million, and a further three million risk losing their jobs over the this year.

As we look back now, in January 2010, we can say with confidence that the worst is behind us. The policies adopted by EU Member States jointly and individually to prop up the financial system and their economies worked. These massive stimulus programmes were necessary in the context of the crisis. But they have left us with a major challenge.

The Challenge

The economic crisis and unprecedented fiscal measures, taken to support the financial sector and limit demand shortfalls, have significantly weakened the state of public finances across the world. The EU's average budget deficit is set to more than double to about 7 percent of GDP this year. Twenty EU member states are expected to breach the 3 percent of GDP deficit threshold of the Stability and Growth Pact. Outside Europe, other leading economies, like the US, Japan, and India, will all be running fiscal deficits over 10 percent in 2009.

In terms of increased indebtedness, the debt-to-GDP ratio in the EU will jump to nearly 80 percent of GDP in 2010, up from 60 percent in 2008. On the basis of unchanged policies, debt ratios would increase to around 120 percent in 2020, and in some countries even up to 200 percent. The Euro area's debt ratio will reach nearly 90% in 2011. Advanced economies' public sector gross debt is forecast to increase from an average of 78 percent of GDP in 2007 to 118 percent in 2014.

The UK's fiscal situation, with a large deficit, a major increase in the debt, and a low sustainability level, is among the most problematic in Europe. The deficit is widening rapidly and is expected to reach around 14 percent of GDP in 2010 according to OECD projections. The gross government debt-to-GDP ratio is on course to reach around 90% by 2010, according to the OECD. In the EU Commission's Sustainability Report, UK public debt is forecast to increase to 160 percent by 2020 and 270 percent by 2030, assuming that no policy changes are adopted. The size of the UK deficit and debt implies that it will soon be necessary to embark on one of the largest fiscal consolidations in peacetime.

Why fiscal sustainability matters

There are many good reasons why strong public finances matter and why countries struggling with growing deficits and debt levels need to embark on a process of fiscal consolidation:

1. **The current situation is not sustainable**. As outlined above, debts are projected to increase dramatically over the next few years, reaching over 100% in some cases. As debt accumulates, risk premiums on government bonds will rise, and countries will have to spend ever-larger amounts servicing debt repayments, thus crowding out welfare services and growth-generating investments. This is not a very attractive future. In some countries, there is a considerable risk of deficits and debts spiraling out of control, with disastrous consequences for the entire economy.

2. Benjamin Franklin once said that the only certainties in life are death and taxes. Well, I'd like to add a third certainty: future economic crises. **We know from experience that there is always another downturn around the corner.** And we need to be ready for it.

This means strengthening our public finances soon and returning to a fiscal position where we will be able to act to stabilize the economy in the next downturn. Experience shows that a process of rising debt ratios is difficult to reverse. Even a decade after the start of a crisis, most governments ran public debt-to-GDP ratios above pre-crisis levels, according to a recent Commission report.

Avoiding a situation where countries enter the next economic downturn with unsustainable public debt positions must therefore be a priority. Such a downturn may well materialise before output gaps have been closed completely, with strong demands for both automatic stabilisers to work, as well as discretionary fiscal policy. If we are not in position, by then, to pursue a sufficiently expansionary fiscal policy, citizens will suffer immensely and government will lose its credibility as a guarantor of the welfare state and societal security.

3. The **demographic challenges facing much of the developed world make sustainable public finances a necessity**, as has been illustrated by the Commission's Ageing and Sustainability Reports, published in 2009. Europe's population is living increasingly longer and healthier lives, a great achievement that we should be proud of. However, ageing populations also pose major economic, budgetary and social challenges.

Low birth rates, rising life expectancy and a continuing inflow of migrants can be expected to result in an almost unchanged, but much older, total EU population by 2060, meaning that the EU would move from having four working-age people (aged 15-64) for every person aged over 65 to a ratio of only two to one. Fewer economically active people will, all else equal, lead to lower economic growth and smaller tax revenues, while more retired people increases the costs of age-related transfers and services. Based on current policies, age-related public expenditure in the EU is projected to rise on average by 4.3 percentage points of GDP by 2060.

The UK will also struggle with the consequences of an ageing society. According to the EU Commission, age-related spending in the UK is projected to increase by nearly 5 percent of GDP by 2060. This will put severe pressure on the public purse.

The United States, too, faces similar challenges. A December 2009 report by the Congressional Budget Office projects that spending on Medicaid and Medicare will double to 10 percent of GDP in the next 25 years, largely driven by an ageing population.

4. The inability to maintain sustainable public finances would **increase the risks of higher equilibrium unemployment and long-term unemployment**, with drastic and

lasting consequences for economic stability and growth. As the long-term unemployed grow discouraged, they tend to drop out of the labour force and become economically inactive. This puts increased pressure on social welfare systems and thus public finances. Moreover, it is very difficult to bring these people back into the labour force and employment. They risk being permanently excluded from working life, with serious implications for their own well-being.

The lessons from Sweden

1. All means must be used

Given the magnitude of the fiscal problems in many of the OECD countries, the fiscal consolidation must be substantial, in some cases up to about 3% percent of GDP per year. For this kind of consolidation to be credible, the government must use all means available, which implies increasing taxes *and* reducing spending. Only focusing on expenditure cuts would excessively harm socio-economically disadvantaged groups, who rely extensively on the social programmes that would inevitably suffer. This is neither politically desirable nor politically acceptable. Only relying on tax hikes would massively distort incentives to work. Moreover, empirical evidence shows that fiscal consolidation based solely on higher taxes is not as effective and does not create as lasting effects as a balanced consolidation, with sizeable expenditure reductions. The key is hence to find an appropriate balance between tax and expenditure adjustments.

In order to achieve its programme of fiscal consolidation in the mid-1990s, the Swedish government chose to rely heavily on both tax increases and expenditure cuts, although spending cuts accounted for a slightly larger proportion of savings (53 percent of total savings versus 47 percent from higher taxes).

2. Taxes

Any government undertaking a comprehensive fiscal consolidation must almost certainly consider increasing taxes, including broad-based taxes, such as consumption taxes. In conducting a tax reform, economic theory holds that one should seek to minimize the general harm to the economy of higher taxes, by focusing on increasing

taxes on those items with negative external effects, such as carbon dioxide, alcohol, and tobacco, and minimizing the burden that falls on income and capital, as such taxes tend to be most harmful to growth.

The OECD has investigated the issue of how to design a tax system promoting economic growth[1] and their study confirms the above principles and the results of the earlier literature on taxes and growth. The main finding is that recurring taxes on immobile property, and to a lesser degree, consumption taxes, appear to have the least impact on growth, while corporate taxes, followed by income taxes, are found to be the most harmful. However, practical tax reform also requires a balance between the aims of efficiency, equity, simplicity and revenue raising. And one must also consider whether a tax is legitimate or not. In the latter respect, the property tax faces special problems. And ultimately, every country, given its own context and history, must chart its own tax course.

Swedish taxes were increased substantially in the mid-1990s. A large portion of these tax hikes were aimed at income and capital. While this was necessary for the consolidation at the time – both to balance the budget and create legitimacy for the programme – it was unfortunate from an structural efficiency point of view.

3. Expenditure

Clearly, any fiscal consolidation programme will always have to rely on substantial spending cuts in order to reach the desired target. However, in analyzing which public programmes and items should be reduced, there are several principles that should be kept in mind. **First**, spending that enhances growth and employment prospects, such as education and training, should, as far as possible, be preserved. **Second**, spending decisions should boost incentives to work and join the labour force, since minimizing the number of economically inactive people is key. This means that social welfare programmes and pension systems should be designed to encourage people to work more, start working at an earlier age, retire later, and stay in the work force. Poverty traps, which arise when effective marginal tax rates of moving from unemployment to employment are too high, must be avoided. **Third**, there must be effective rules and

[1] ”Taxes and Economic Growth”, OECD, Economics Department Working Paper No.620

regulations governing welfare programmes, with appropriate controls, so that money truly reaches those who need them.

Fourth, savings must be structurally sound, forward-looking, and not target key public investments, such as road or railway maintenance, or other vital infrastructure projects. Research and development spending is another area of productive public investment that should not be cut. Such savings are stop-gap measures that will need to be reversed soon, to maintain a functioning infrastructure. One-off measures that do not contribute to a lasting consolidation should be avoided.

The expenditure cuts made in Sweden in the 1990s focused largely on government transfers, such as pensions, early retirement benefits, housing subsidies, as well as social and unemployment insurance. Cutting back on such programmes is always difficult, but compared to saving on the core functions of the welfare state – hospitals and schools – this is the lesser of two evils. And in a period of fiscal retrenchment, political leadership means making tough decisions, which are unpopular but necessary.

4. Improve the baseline scenario

In implementing a fiscal consolidation, it is important to ensure that major expenditure programmes are not indexed to inflation, as this kind of indexing automatically erodes much of the intended savings. This happened in Sweden in the early 1990s, when we tried to implement various savings.

Today central government grants to local government and several allowances such as child allowance and student grants are fixed in nominal terms in Sweden. These are items that are politically quite important. Since the appropriations are nominal, the cost of these grants gradually decreases if no decisions are taken in this regard. Hence the baseline is constantly improving, unless a discretionary decision is taken to increase spending on these areas.

Another important feature of the Swedish fiscal policy framework is that the price and wage indexing of appropriations to central government agencies – that is, the upward adjustment of costs for items such as wages – is adjusted for productivity every year.

The adjustment thus includes a deduction equalling the average productivity growth of white-collar workers in the service sector during the last ten years. For the 2010 fiscal year, the productivity deduction was 1,5 percentage points.

This means that an agency often receives funding increases below inflation – a decreasing level of real funding – which in turn helps limit expenditure increases and creates incentives for government agencies to constantly innovate and raise efficiency.

5. Do not be disappointing: create a conservative baseline

Credibility is central to any successful consolidation process. The government in general and the Minister of Finance in particular must establish credibility with markets, investors, analysts, and the public. The country must be seen as trustworthy, as committed to its promises. Such credibility is worth a lot: a non-credible fiscal policy will lead to higher interest rates, increased costs of borrowing, speculation, and, ultimately, default on loans.

Credibility is a function of many factors. It depends on transparency and honesty: being up-front about one’s goals, the time required to reach them, and key calculations. It depends on delivering realistic and accurate, but not overly optimistic, forecasts, so that external observers are not disappointed by the results. It depends on exceeding, or at least living up to expectations, and never underperforming. Conservative assumptions regarding key macro-economic data are of the essence. Ultimately, credibility is about building a reputation of competence and consistent performance, which creates trust among markets that you will deliver. This, in turn, will lower interest rates and borrowing costs.

In creating a conservative baseline, one should have a readiness to deal with unexpected events, which may threaten the underlying baseline. This means having additional savings proposals in one’s back pocket, which can be used if a target is likely to be missed.

Upon embarking on its consolidation programme, the Swedish government spent considerable time and effort on achieving credibility with financial markets. When

the OECD and European Commission have evaluated Swedish fiscal policy, forecasts have found to be accurate, up front and with a built-in conservative bias. Most importantly, during the consolidation, forecasts were consistently met and even at times exceeded, thus building confidence among investors.

6. Front load the consolidation

It makes sense, both politically, economically, and psychologically, to begin and to do as much of the consolidation as soon as possible after having received a political mandate to do so. There is then a window of opportunity to act, as the public has, hopefully, voted for such a policy and – at the very least – understands the need to shore up public finances. The longer one waits with the heavy lifting, the more difficult it becomes.

From a political point of view, starting earlier also increases the prospects of being able to show results before the next election. Moreover, as alluded to above, acting now creates political (and economic) room for manoeuvre at a later stage, such as a future crisis, when deficit spending will be needed again.

From an economic perspective, front-loading reduces the future borrowing costs. It also signals the intention of the government to act – to do something about the situation – which will boost credibility. As the saying goes, “Actions speak louder than words.”

The Swedish government certainly front-loaded its savings in dealing with the crisis of the early 1990s. Key decisions were taken already in 1992 and 1993, including the de-linking of certain benefits to inflation and the introduction of productivity adjustments to price and wage indexing . Indeed, about half of all savings were decided on by 1994. The result was that the deficit, which in 1994 had been over ten per cent, had been reduced to 2 per cent by 1997.

7. Calculate the political cost: public choice

One should be aware of the interest groups defending various policy areas and the political costs associated with taking on these special interests. It may not make sense to push through large savings on a small, well-organised group, which will protest

loudly and at length. Rather, one needs to dare to take on large groups, where cuts will yield large savings.

However, sometimes one must pursue more symbolic savings, which are not worth a lot of money, but send a strong message about the government's will. One such area is the remuneration of politicians or leading civil servants. For example, restructuring the benefits and compensation of Members of Parliament or Ministers reinforces the gravity of the situation.

8. Safeguard labour force participation

The long term sustainability of public finances rests ultimately on safeguarding labour force participation, especially in a welfare state, with high tax levels. A higher labour force participation leads to more hours worked in the economy and lower unemployment, which in turn generates higher tax revenues and puts less pressure on social welfare programmes.

Maximising labour force participation is particularly important in a context of an ageing society. As the population grows older and incomes rise, the demand for welfare services will increase. In the UK, as in most developed countries, the number of people aged 65 or over will increase rapidly in the next 30 years, while the increase in the group aged 20–64 is expected to be more modest. According to the EU Commission, age-related spending in the UK is projected to increase by nearly 5 percent of GDP by 2060, which is close to the EU average.

In pursuing fiscal consolidation, a government must pay attention to how its tax and spending reforms affect labour force participation. More concretely, this translates into a number of Do's and Do-not's in terms of policy formulation.

First, the government should evaluate its benefit system, and examine how this can be reformed to make it more worthwhile to work. This means considering the size and/or duration of unemployment benefits, social security payments, and other benefits that may serve as disincentives to seeking employment. Second, the government should also ensure that there is an adequate cost control and oversight mechanism concerning the benefits systems, so that welfare payments are truly going to those who need them

the most. A key aspect involves people not being forced out of the labour force into a welfare programme, such as early retirement, if they do indeed still have the ability to work. Finally, active labour market policies play a key role in safeguarding labour force participation. They helped dampen the effects of the economic crisis in the early 1990s and they are indeed highly relevant today as well.

What should be avoided in a consolidation? Well, any and all spending that contributes to maintaining labour force participation, such as subsidized child care, education, and active labour market policies, should be shielded from cuts. In some cases, it may even be justified to increase investments on such items, to maintain labour force participation rates. In particular, spending that strengthens female work force participation should be preserved. Actions that intensify poverty traps, such as the introduction of means-testing, must also be resisted.

The current Swedish government has promoted labour force participation by pursuing a number of reforms to make work pay. Perhaps most importantly, we have significantly reduced marginal tax rates for low and middle-income earners through the introduction of a earned income tax credit (EITC). This is a crucial structural reform in helping people move out of the poverty trap. In fact, low and middle-income earners have received two thirds of total tax cuts, thus markedly reducing their total tax burden.

We have also restructured the functioning of the benefits system, to further incentivize people to shift from unemployment, early retirement, and other welfare programmes into employment. In addition to making it more profitable to employ people who have long been excluded from the labour market, we have strengthened measures to support the unemployed in their job search. Furthermore, the Swedish Public Employment Service, responsible for helping people currently out of work find new jobs, has been improved.

These reforms have helped Sweden weather the current economic crisis. **First**, unemployment has increased less during the crisis than we expected. Compared to the most pessimistic earlier forecast the current prognosis is that unemployment will be significantly lower during 2010-2012 and have been revised downwards between 0.7 to 1.6 percentage points per year. More stable financial markets in combination with

extensive fiscal and monetary stimuli have raised demand, which in turn have made the effects on the labour market less severe. **Second**, and related to the first point, the costs associated with unemployment will also be less than expected. The labour market related expenses is now projected to be 7 per cent lower for 2011 than projected last spring. If one does not take into account recent reforms in the budget bill for 2010 the labour market related expenses would be even lower, around 13 percent. **Third**, the costs for early retirement and sick leave have fallen dramatically in the last few years. In fact, in 2006 to 2011, the accumulated cost savings are in the order of about 70 billion Swedish kronor (almost 6 billion pounds sterling). **Fourth**, according to the latest forecast, hours worked in the Swedish economy – the most important tax base – will develop substantially better than projected earlier. Previously we saw a decrease in hours worked by 3 percent between 2009 and 2012. Now we believe that hours worked will marginally increase during the same period, leading to higher tax revenues. **Fifth**, unlike many other countries, Sweden will not have to engage in a painful fiscal consolidation, owing to our robust public finances. The 2010 average fiscal balance in the OECD is -8 per cent of GDP. Sweden is among the countries with the smallest deficits, having a fiscal balance at -3 per cent of GDP. Sweden also has among the most sustainable public finances in the EU according to the European Commission's *Sustainability report 2009*. So, the economic crisis that has devastated many of the world's leading economies has not hit Sweden as hard as we had feared. This may be a sign of the effectiveness of the current government's reforms.

9. Strengthen fiscal institutions

There is widespread agreement that fiscal policy frameworks matter. A wide range of empirical studies show that countries with stronger fiscal institutions, including centralized policy-making, fiscal rules concerning deficits and multi-annual expenditure ceilings, and transparent procedures, achieve better fiscal outcomes, in terms of lower deficit and debt.

This is why many countries have reformed their fiscal institutions during the last couple of decades, and why the EU has made stronger fiscal policy frameworks a key part of the Göteborg principles for comprehensive fiscal exit strategies, agreed at the informal ECOFIN Council meeting in October 2009, during the Swedish Presidency.

Sweden reformed its fiscal framework in the mid-1990s, since the previous system was among the worst in Europe, as had been illustrated by poor outcomes in public finance terms. We now have a robust system with a surplus target of 1 percent over the economic cycle, a multi-annual expenditure ceiling, a centralized top-down budgetary process, in which the Ministry of Finance has a strong co-ordinating role, and a statutory balanced budget requirement for local governments. There is also a fiscal policy council that independently evaluates the government's fiscal policy, including its long-term sustainability, the surplus requirement, and the multi-annual expenditure ceilings.

Since the introduction of stronger, more effective rules, public finances have improved substantially in Sweden. Deficits have been replaced by surpluses and the public debt as a percent of GDP has fallen steadily from its peak in the mid 1990s to under 40 per cent by 2007. This also means that Sweden today has room to manoeuvre in taking measures to combat the financial crisis.

Fiscal frameworks vary across the OECD, in terms of centralization of budgetary power, the existence of formalized expenditure ceilings and/or surplus targets, and various other rules. Given the relatively poor fiscal performance of various countries with weaker budgetary institutions, it would seem justified that they introduce stronger fiscal rules and processes, along the lines recommended by the OECD.

While the OECD acknowledges that fiscal institutions need to be adapted to the country-specific context, it also emphasizes that certain features are necessary for the rules to be effective, including the "need to combine transparency with sufficient flexibility to face cyclical (and other) shocks, a wide coverage across various budget items and effective enforcement mechanisms." It is also important that there is clarity regarding the timing of an economic cycle, and that changing assessments of the cycle's start date do not prevent the functioning of the fiscal rules.

In the case of the UK, the OECD has suggested amending its fiscal rules so that they are forward looking, ensure medium-term spending discipline and account more explicitly for off balance sheet public liabilities. Also, income tax thresholds and

national insurance thresholds should be linked to wage, rather than price inflation so that fiscal drag is handled more transparently.[2]

Ultimately, a country's fiscal institutions are best assessed according to that country's fiscal outcomes, ie the evolution of debts and deficits. Given the relatively poor fiscal performance of the UK and many other states, it seems clear that a comprehensive reform of budgetary rules and procedures is in order.

10. Maintain social cohesion

A fiscal consolidation process must not come at the expense of social cohesion. It should not harm the poorest members of society, but rather the burden must be shared by all, in an equitable fashion, with the richer taking on a larger burden, in proportion to their greater wealth. This is crucial in ensuring that a consolidation has sufficient legitimacy in a society. Social justice requires us all to do our part because we are all in this together.

More robust fiscal institutions, as described above, should also contribute to social cohesion, by protecting the poorest, who suffer when weak public finances necessitate fiscal consolidation. In the case of Sweden's consolidation, the two richest deciles accounted for 43 percent of the savings, whereas the other deciles each contributed about five to ten percent (with the poorest deciles accounting for the least).

Conclusion

The value of sound public finances cannot be underestimated. Weak public finances are a **major source of instability**, as the market and the public question the direction and credibility of government fiscal policy. The costs of this uncertainty are manifested in terms of a risk of higher interest rates, increased inflation, and the strong likelihood of forced fiscal consolidation, through higher taxes and reduced spending. Such a consolidation process is painful, particularly for the poorest members of society, whose welfare programmes are disproportionately cut. The **value of stable, robust public finances** is then that it reinforces the credibility of

[2] OECD and the EU Commission 2009.

government policy, thus allowing fiscal stimulus programmes to have effect, as individuals don’t need to hold back consumption, for fear of future tax increases.

In conclusion, it is clear that a number of OECD states, including the UK, face a challenging situation, in terms of public finances. A fiscal consolidation will be necessary to deal with the high deficit and growing debt levels. However, Sweden and other OECD countries have been in similar positions yet have successfully restored robust public finances.

The key lessons from Sweden’s fiscal restructuring of the early 1990s include the need to use both tax increases and expenditure cuts; the importance of raising the right taxes and cutting the right expenditures; the significance of realistic yet ambitious forecasts; and the necessity of front loading consolidation. Calculating the political costs of various reforms, creating robust fiscal policy frameworks, and maintaining social cohesion are other key elements of a successful consolidation.

The current Swedish government’s structural reforms, including tax and spending changes, welfare reforms, and measures to safeguard labour force participation, have further strengthened the Swedish economy and public finances, dealing with structural problems that remained unresolved from the 1990s. These reforms have played a key role in helping Sweden’s public finances survive this downturn relatively unscathed.

I am confident that the UK, with strong political leadership and appropriate policy decisions, will address its fiscal challenge and bring public finances back to a sustainable path.