SPECIAL ANALYSIS

Consequences of a balanced-budget target for public finances

In March 2015 the Swedish government asked the NIER to assess the consequences of switching from the surplus target introduced in the year 2000 to a balanced-budget target for general government net lending. This special analysis summarises the most important conclusions.[75] A gradual rise in the dependency ratio in the coming decades will put upward pressure on public spending. The surplus target has helped put public finances in a good position to meet this challenge, but if the public sector commitment is to be maintained at current levels, taxes will still have to be raised, even with a balanced-budget target. Switching to a balanced-budget target will not create space for lower taxes or higher spending in the very long term, but will bring some temporary space through to 2040. A balanced-budget target will reduce fiscal buffers and so also the scope for using fiscal policy to stabilise economic performance.

A surplus target and a balanced-budget target

The **surplus target** introduced in the year 2000 requires general government net lending to average 1 per cent of GDP over a business cycle. The target was originally set in the 1997 Spring Fiscal Policy Bill as a surplus of 2 per cent of GDP over a business cycle, but was lowered to 1 per cent after Eurostat decided in 2007 that net lending in the premium pension system (which amounted to 1 per cent of GDP) should be posted to the household sector.

A **balanced-budget target** means that general government net lending should average 0 per cent of GDP over a business cycle.

The choice of target is not expected to affect employment in the long term. In the short term, however, employment growth will be held back somewhat if fiscal policy is geared towards the existing surplus target rather than a balanced-budget target. Fiscal tightening during an economic upturn is, however, a natural part of an ambitious stabilisation policy. Attaching excessive importance to short-term effects when choosing a budgetary target would damage the credibility of fiscal policy.

TARGET'S CREDIBILITY IS KEY

One starting point for the analysis is the importance of fiscal policy credibility. A lack of credibility can, for example, lead to inflated risk premiums on central government borrowing and make it harder to collect taxes, thus jeopardising fiscal sustainability. But credibility is not just critical for the sustainability of public finances – healthy economic performance in general depends on firms and households being able to make decisions on consumption, saving, investment and employment on the basis of properly anchored expectations about economic developments. This is a fundamental argument behind the inflation-

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[75] The full report was published on 14 August 2015 in ”Konsekvenser av att införa ett balansmål för finansiellt sparande i offentlig sektor” [Consequences of introducing a balanced-budget target for general government net lending], *Specialstudie* 45, NIER, 2015.

An unchanged public sector commitment

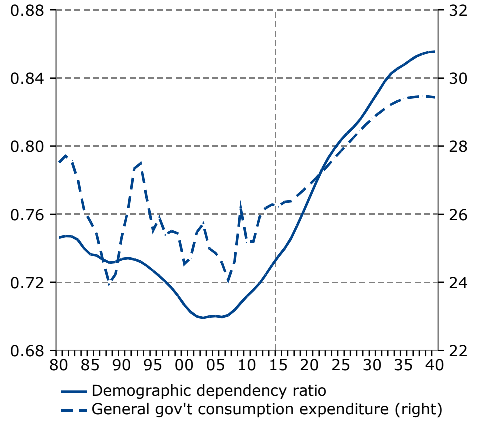
There is no universally accepted definition of an unchanged public sector commitment.

Under the NIER's definition, general government consumption grows at such a rate that personnel density in the production of welfare services is unchanged, and replacement rates for social transfers are maintained (i.e. transfer payments per person rise in line with hourly earnings). Central government investment also increases at the same rate as potential GDP, and local government investment at the same rate as local government consumption.

According to the NIER's calculation methods, this means that general government consumption and investment will be constant as a share of GDP with unchanged demographics.

Diagram 140 Demographic dependency ratio and government consumption expenditure

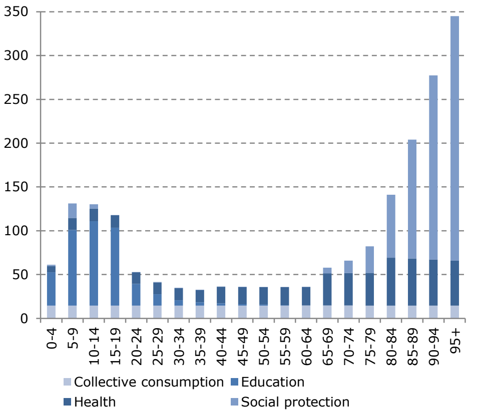
Non-working-age population relative to the working-age population, and per cent of GDP, respectively



Sources: Statistics Sweden and NIER.

Diagram 141 Average cost per person for government consumption in various age groups (2012)

SEK thousand per year



Source: Statistics Sweden.

targeting policy pursued in Sweden since the 1990s and also applies to fiscal policy to a great extent.

Fiscal policy credibility is easier to achieve with a widely supported target. Credibility will also benefit if the target steering fiscal policy supports the fundamental objectives of economic efficiency, fiscal sustainability, generational equality and buffers to counter major shocks to the economy. This lends the target legitimacy. Another aspect is that a target should promote fiscal discipline. It is important for this reason that there is a close link between target fulfilment and political decisions. The target should not be met through manipulation. It can be assumed that the risk of this will be reduced if the target is all-encompassing and not subject to interpretations of varying validity. The Swedish budgetary process, with its "top-down" decision-making model and a strong holistic perspective, promotes the credibility of fiscal policy and is worth safeguarding. The fact that the target relates to net lending, which is calculated on the basis of international conventions, also enhances its credibility.

AGEING POPULATION TO PUT PRESSURE ON PUBLIC FINANCES

Sweden is entering a period where public spending can be expected to increase as a share of GDP due to demographic developments if the public sector commitment is to be maintained (see box in margin). The background to this is a rise in the demographic dependency ratio in the coming decades (see Diagram 140). The dependency ratio decreased throughout the 1980s and 1990s and in the early 2000s, but has been rising since 2005 and is expected to continue to climb through to the late 2030s.

This increase in the dependency ratio means that the number of people with a relatively large need for welfare services will grow more quickly than the number of people who are in work and so account for the bulk of the tax base. The greatest need for welfare services is among the elderly, especially those over 80 (see Diagram 141). This is also the age group that is expected to grow most quickly. As a result, general government consumption – in particular care for the elderly – will increase as a share of GDP if the public sector commitment is kept at current levels.

SURPLUS TARGET HAS ENHANCED CREDIBILITY OF FISCAL POLICY

Sweden has had a surplus target since the year 2000. Demographic developments, with growing pressure on public spending expected from the mid-2000s onwards, contributed to the target coming about, but a need to consolidate public finances was pivotal in its introduction. The economic crisis of the 1990s led to large deficits in public finances, and central government debt spiralled. Besides furthering the fundamental objectives of fiscal policy, the target was intended to help reduce central government debt and bring assets and liabilities in the government sector into balance – in other words, net wealth close to zero. The reason for this was partly that liabilities were already considered to be too high, and partly that there was now a chance to "top up the coffers" in the early 2000s ahead of the anticipated rise in the dependency ratio.

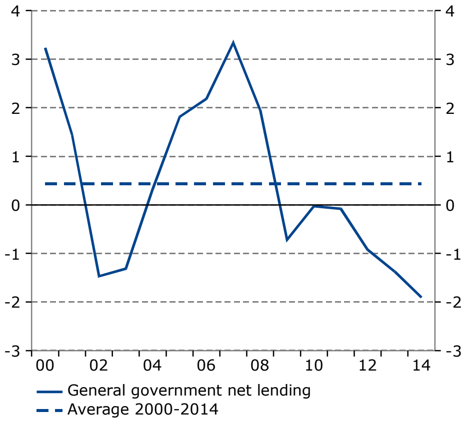
General government net lending has averaged 0.4 per cent of GDP since the year 2000 (see Diagram 142). In other words, it has fallen short of the target. Public finances have nevertheless performed well. General government debt has fallen, and net debt has turned into net wealth equivalent to almost 20 per cent of GDP (see Diagram 143). The surplus target has contributed to this change, because net lending has still been positive during the period despite undershooting the target. The NIER also believes that the target has contributed positively to general economic performance by helping increase the predictability of economic policy, which is good for investment, consumption and employment. However, the improvement in general government net wealth has been driven above all by value changes (see box in margin), namely increases in the value of the shares held by central government and the old-age pension system. This has laid strong foundations for public finances.

EITHER TARGET SPELLS HIGHER TAXES WITH UNCHANGED PUBLIC SECTOR COMMITMENT

The status of public finances ahead of the coming demographic challenge is mixed. On the one hand, the government sector has significant net assets and limited liabilities, which means that there is no acute need to increase wealth or reduce debt. On the other, general government net lending is in negative territory. Last year the deficit was close to 2 per cent of GDP. Net lending is expected to improve in the coming years due to the economic recovery and the restrictive fiscal policy proposed by the government. It will, however, remain in deficit until 2018, after

Diagram 142 General government net lending

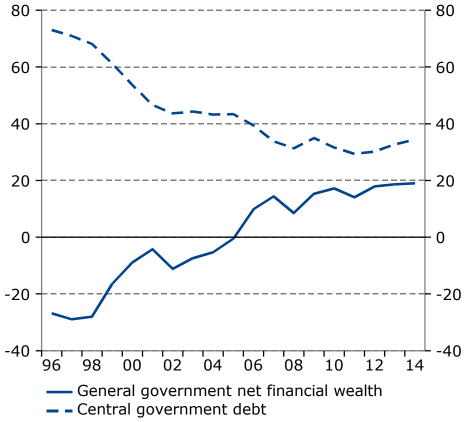
Per cent of GDP



Source: Statistics Sweden.

Diagram 143 General government net financial wealth and central government debt

Per cent of GDP



Sources: Statistics Sweden and NIER.

Movements in general government net financial wealth

General government net financial wealth will increase in absolute terms if net lending is positive or if there are positive value changes. **Value changes** are all changes in net wealth that are not included in net lending. This might mean changes in the value of shares, sales of assets above or below their book value, and pure accounting adjustments that affect the value of assets or liabilities but not net lending.

General government net financial wealth will increase as a share of GDP if the sum of net lending as a share of GDP and value changes as a share of GDP exceeds GDP growth (in current prices) multiplied by the previous year's net wealth as a share of GDP.

Measures of general government net lending

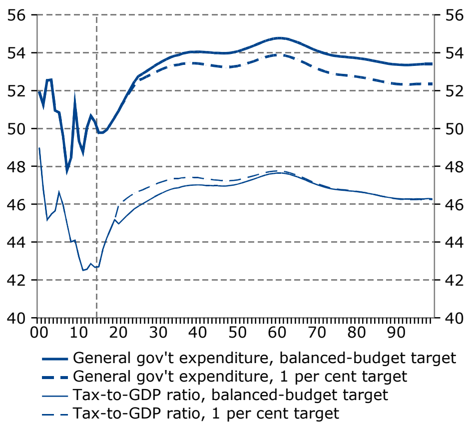
General government net lending is the difference between (accrued) income and expenditure in the government sector during the course of a year. The government sector can be subdivided into central government, local government (municipalities and county councils) and the old-age pension system.

General government primary net lending excludes capital income and capital costs (in practice, mainly interest costs).

Structural net lending is an estimate of what general government net lending would be with normal resource utilisation. The difference between structural and actual net lending corresponds to the automatic stabilisers (see below) and non-recurring items (such as repayments of insurance premiums to municipalities).

Diagram 144 General government expenditure and tax-to-GDP ratio

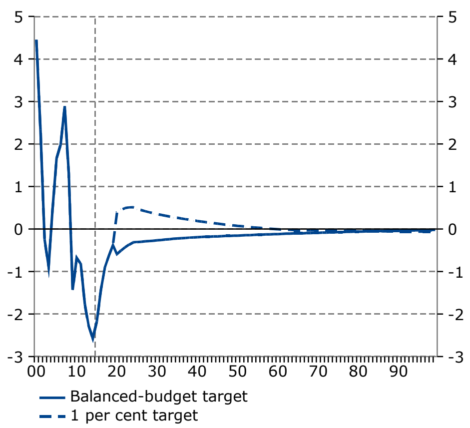
Per cent of GDP



Source: NIER.

Diagram 145 General government primary net lending

Per cent of GDP



Sources: Statistics Sweden and NIER.

which small surpluses are expected. All in all, this means that the tax-to-GDP ratio will climb 2.5 percentage points by 2019 with an unchanged public sector commitment.

Demographic developments mean, however, that the pressure on public spending will continue to mount after 2019. The tax-to-GDP ratio will therefore have to keep on climbing through to 2040 if the public sector commitment is to be maintained, even if the surplus target is replaced with a balanced-budget target (see Diagram 144).

The long-term effect on the tax-to-GDP ratio of a balanced-budget target versus a surplus target of 1 per cent is illustrated in Diagram 144, which shows the levels of taxation needed to achieve the respective targets. The difference in the tax-to-GDP ratio starts at 1 percentage point but then decreases: by 2040 it is just 0.4 percentage points, and from 2060 onwards it is the same with either target.

The reason why the tax-to-GDP ratio is the same with a surplus target as with a balanced-budget target in the long term has to do with interest costs. With a surplus target, central government debt can be repaid, bringing down interest costs. In the long term, the lower interest costs with a surplus target mean that the tax-to-GDP ratio is more or less the same as with a balanced-budget target.

NO FISCAL SPACE WITH BALANCED-BUDGET TARGET IN NEXT FIVE YEARS OR VERY LONG TERM

Fiscal space is usually defined as the level of unfunded measures compatible with achieving the surplus target. This definition implies that a lower target will create more fiscal space. However, general government net lending is currently far from the target level – last year saw a deficit close to 2 per cent of GDP. In the NIER's June 2015 forecast[76], net lending remains negative until 2018 despite the economic recovery and despite fiscal policy being assumed to be restrictive in the coming years. The fact that net lending does not balance until 2018 means that there is no fiscal space on this horizon, even with a balanced-budget target.

Nor will switching to a balanced-budget target bring any more space for tax cuts or spending increases in the long term than an unchanged surplus target of 1 per cent of GDP. This is for the same reason that the tax-to-GDP ratio will be the same with an unchanged public sector commitment whatever the

[76] Used as the basis for the calculations.

target. The lower net lending that a balanced-budget target entails means that central government debt will be higher in the long term, and so general government interest costs will be higher than with a surplus target. In the long term, the difference in net capital income (interest income and returns less interest costs) will be almost 1 per cent of GDP. This means that *primary* net lending (net lending excluding net capital income) will be the same in the long term whatever the target (see Diagram 145). Making the reasonable assumption that the difference between GDP growth and interest rates will be small, it can be shown that primary net lending in the long term will be close to zero whatever the budgetary target. This means in turn that a balanced-budget target will not create any long-term space for lower taxes or higher spending. In the long term, all primary expenditure (general government consumption, transfers and investments) needs to be funded with equal amounts of tax revenue.

LIMITED SPACE FOR LOWER TAXES IN 2020−2040 IF SURPLUS TARGET IS REPLACED WITH BALANCED-BUDGET TARGET

During a transition period following the introduction of a balanced-budget target, there will, however, be a slight difference in primary net lending in the two scenarios, as primary net lending will be lower with a balanced-budget target than with a surplus target (see Diagram 145). Switching to a balanced-budget target will therefore permit lower taxes and/or higher public spending for a number of years after 2020. Initially the difference is 1 per cent of GDP, corresponding to the difference between the targets, but the difference decreases as central government debt (and so interest costs) increases with a balanced-budget target. By 2040 the difference narrows to 0.4 per cent of GDP, and the average difference in primary net lending in 2020−2040 is just 0.6 per cent of GDP. This corresponds to around SEK 25 billion in today's money, which is roughly the size of the "reforms" proposed in the government's budget bills in recent years. Thus the temporary space created by a balanced-budget target can be assumed to be equivalent to one annual budget's worth of measures not needing to be funded. But it is important to remember that if this space is used for permanent measures, these will have to be withdrawn or matched with equivalent savings in the long term, because no long-term space is created by switching to a balanced-budget target.

The EU's fiscal framework

As an EU member state, Sweden has a duty to comply with the requirements of the Stability and Growth Pact (SGP). The aim of the pact is to ensure healthy public finances in the EU as a basis for effective economic and monetary co-operation within the union. The pact has its roots in the Maastricht Treaty and has been revised and extended on a number of occasions over the years. The SGP consists of a preventive arm and a corrective arm, and sets out reference values limiting member states' budget deficits to 3 per cent of GDP and general government debt to 60 per cent of GDP.

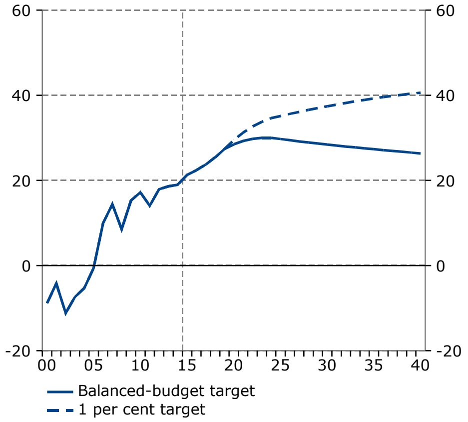
Under the preventive arm, each member state must have a medium-term budgetary objective (MTO) for general government structural net lending. The aim of the MTO is to provide a safety margin to the deficit reference value of 3 per cent of GDP. The MTO is also intended to ensure the sustainability of public finances by contributing to sustainable debt levels and providing room for budgetary manoeuvre. Sweden's MTO is currently −1 per cent of potential GDP. The objective is revised every three years, and the next revision will take place at the end of 2015. Should structural net lending deviate from the MTO, the member state must return it to the target level at a satisfactory rate. The guideline is an improvement of 0.5 per cent of GDP per year in a normal economic climate. Structural net lending is not directly observable but has to be estimated using models. If a country breaches the rules in the preventive arm of the SGP, the European Council may issue recommendations on appropriate action to rectify the situation.

The corrective arm of the SGP addresses deficits in excess of 3 per cent of GDP and debt in excess of 60 per cent of GDP. The principal instrument is the Excessive Deficit Procedure (EDP), which is opened if a member state's deficit exceeds 3 per cent of GDP or debt exceeds 60 per cent of GDP. The EDP involves close monitoring of the member state's public finances by the European Commission and the European Council. This can lead to recommendations on changes to be made to public finances, or suspension of commitments or payments from the EU's structural and investment funds.

There are a number of exemptions in the EU rules that allow a country to avoid the EDP even if the aforementioned limits are exceeded. For example, an exemption from the 3 per cent deficit rule may be granted in the event of a severe economic recession in the euro area or the EU.

Diagram 146 General government net financial wealth

Per cent of GDP



Sources: Statistics Sweden and NIER.

Fiscal policy terms

Automatic stabilisers mean that general government net lending varies with the business cycle even without any active decisions being made. When economic conditions are weak, net lending will deteriorate even without any decisions on tax cuts or spending increases. This is partly because tax revenue will fall when output is lower than normal, while much of the government's spending is unaffected; and partly because unemployment-related expenditure will be higher than normal when unemployment is above the equilibrium level. The stronger the automatic stabilisers, the more cyclically-sensitive public finances will be. The strength of the automatic stabilisers is often measured as **budgetary elasticity**, which shows by how many percentage points general government net lending as a share of GDP will automatically fall with a 1 percentage point decrease in the output gap.

Unchanged rules mean that it is assumed that no further fiscal policy decisions will be taken by the government or parliament. With unchanged rules, there will be no **unfunded measures** – in other words, no fiscal policy decisions to increase expenditure and/or decrease taxes that are not matched by decisions to decrease expenditure and/or increase taxes in other areas by the same amount. Unchanged rules are normally associated with an **automatic budget-strengthening effect**. This strengthening is a result of tax revenue moving largely in line with GDP with unchanged rules, while expenditure tends to fall in relation to GDP. This automatic tightening will occur for as long as no unfunded measures are introduced.

Fiscal space is the size of permanent unfunded measures in the central government budget that can be accommodated within the target set for general government net lending over a certain number of years.

SUSTAINABLE FINANCES WITH EITHER TARGET

Net wealth as a share of GDP is determined in the long term partly by net lending as a share of GDP and partly by value changes. It can be shown that, in the long term, net financial wealth as a share of GDP corresponds to the ratio between net lending as a share of GDP and GDP growth plus the ratio between value changes as a share of GDP and GDP growth. In the absence of value changes, general government net wealth will therefore fall from its current level of almost 20 per cent of GDP to zero in the long term with a balanced-budget target. However, the absence of value changes is not a reasonable assumption. A substantial percentage of the assets in the government sector, especially in the old-age pension system, consist of shares, and increases in share prices result in value changes in the national accounts. Value changes have been significant in recent decades, and further value changes can be expected to occur in the future, albeit not to quite the same degree as before. Value changes mean that net financial wealth varies relatively little in the period to 2040 with a balanced-budget target and ends up around 25 per cent of GDP in 2040 (see Diagram 146). This is based on relatively conservative assumptions for the return on the government sector's shareholdings.

ACTIVE FISCAL POLICY REQUIRES BUFFERS

Maintaining sufficient buffers that fiscal policy can be used to counter cyclical downturns is a fundamental objective of fiscal policy. Buffers are needed so that the sustainability of fiscal policy is considered credible even if net lending temporarily drops and central government debt rises. These buffers are thus intended to prevent negative reactions, for example in the form of inflated risk premiums on central government borrowing costs. To avoid reactions of this kind, government debt and net lending deficits must not be excessive, although it is genuinely difficult to determine where exactly to draw the line for when fiscal policy begins to lose credibility. There are also rules at EU level that limit the budget deficit to 3 per cent of GDP and general government gross debt to 60 per cent of GDP, and Sweden has also undertaken to keep structural net lending above −1 per cent of potential GDP (see margin on previous page).

PUBLIC FINANCES NOT ESPECIALLY CYCLICALLY SENSITIVE

The size of the buffers required depends partly on how cyclically sensitive public finances are and partly on how ambitious stabilisation policy is. Sweden's public finances are no longer especially cyclically sensitive – in other words, the automatic stabilisers are not particularly strong (see box in margin on previous page for definitions of fiscal policy terms). Net lending would not, therefore, be expected to deteriorate sharply as a result of the automatic stabilisers. According to the NIER's calculations, a budgetary elasticity of 0.3–0.5 can be expected in an export- and investment-led economic downturn of the type seen most commonly in Sweden in recent decades. Thus, if GDP falls by 1 per cent below its potential level, general government net lending as a share of GDP will decrease by 0.3–0.5 percentage points. Where a downturn is driven instead by domestic consumption, the cyclical effects will be greater and budgetary elasticity of 0.6 can be expected.

How far net lending deteriorates in a downturn does not, however, depend solely on the automatic stabilisers. One factor that limits deficits in a downturn is the automatic budget-strengthening effect of unchanged rules. Net lending is also affected by the nature of active fiscal policy. The combined effect of automatic stabilisers, automatic budget strengthening and active policy on net lending determines how much fiscal policy contributes to economic stabilisation. For a given budgetary elasticity, active discretionary policy can be adjusted so that overall stabilisation policy reaches the desired level. The more ambitious the policy for stabilising the economy, the greater the buffers needed to avoid breaches of the EU rules and maintain the credibility of fiscal policy.

LARGER BUFFERS WITH A SURPLUS TARGET

Switching to a balanced-budget target will reduce these buffers. The NIER considers the most pertinent buffers to be those determined by the EU's limits for the budget deficit and general government debt. The reason for this is that these limits are sufficiently tight that they will be reached long before negative market reactions affect Sweden's opportunities to pursue stabilisation policy. The margins to the EU's limits for both general government debt and net lending will obviously be smaller with a balanced-budget target. However, the margins to the debt limit will still be significant even with a balanced-budget target, as Maastricht debt can then be expected to be around 40 per cent of GDP in 2040, compared with just under 30 per cent with a surplus target (see Diagram 147). At the same time, net wealth is positive and significant whatever the target.

Measures of public debt

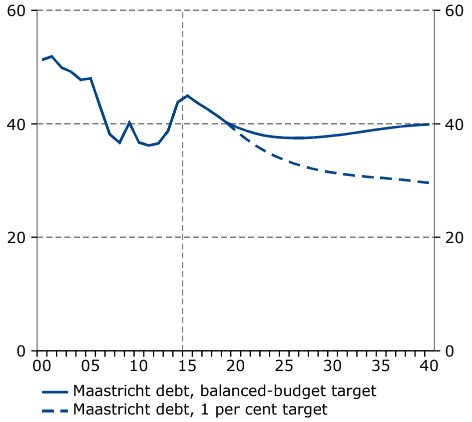
General government consolidated gross debt (Maastricht debt) is the sum of the liabilities that central government, municipalities, county councils and the old-age pension system have to lenders outside the government sector. It is consolidated in the sense that liabilities within the government sector are eliminated. Maastricht debt is a gross measure of debt in that it is not netted against financial assets. Debt instruments are included at their nominal value – in other words, the amount to be paid when the instruments (loans) mature. This measure of debt is defined centrally at EU level, which makes it comparable across all member states.

Central government debt consists of central government's liabilities to other sectors of the economy. It is published monthly by the Swedish National Debt Office using an official definition based on guidelines issued at EU level. The government, the Swedish National Financial Management Authority (ESV) and the NIER report central government debt in consolidated form, which means that liabilities between central government entities are eliminated. Such intra-sector liabilities amounted to around SEK 50 billion in 2014 and consist mainly of various central government bodies' holdings of government bonds. Like Maastricht debt, central government debt is reported at nominal value in line with the official definition and is a gross measure which does not take account of central government's financial assets.

General government net financial wealth consists of the government sector's financial assets less its liabilities. It is sometimes also referred to as the government's net financial position, and negative net wealth is known as net debt. Net financial wealth is computed in Statistics Sweden's financial accounts, which recognise liabilities and financial assets at market value rather than nominal value. This means that **central government gross debt in the financial accounts** is not directly comparable with central government debt or Maastricht debt. The financial accounts also include more types of liability than Maastricht debt and central government debt. Furthermore, liabilities are not consolidated in the financial accounts, either within or between sectors.

Diagram 147 General government debt

Per cent of GDP



Sources: Statistics Sweden and NIER.

The buffer for net lending will decrease by 1 percentage point following a switch to a balanced-budget target. Net lending can then fall from zero with the economy in equilibrium (normal resource utilisation) to −3 per cent of GDP without exceeding the EU limit. It is not particularly likely that this will be a limitation in a normal economic scenario. With an output gap of around −2 per cent, the automatic stabilisers can be expected to result in a deficit of no more than 1 per cent of GDP, which leaves space for further active policy. Normal economic fluctuations of this kind can also be managed to a great extent via monetary policy.

More relevant in this context, however, are the restrictions that smaller buffers impose on fiscal policy in the event of a major domestically-generated crisis where the effects on public finances can be expected to be greatest. In downturns of this kind, which have been unusual historically, a negative output gap corresponding to 5 per cent of GDP would be enough for the EU's deficit limit to be reached solely on account of the automatic stabilisers. A downturn this deep may not be common, but did occur in the crisis of the 1990s. In such a situation, a surplus target will put fiscal policy in a better position. At the same time, it should be remembered that in exceptional situations of this kind there are exemption clauses in the EU rules that permit higher deficits to counter the crisis. Tolerance of deficits on the part of both the EU and financial markets can also be expected to be greater if debt is limited and net wealth is positive.

The NIER would argue that fiscal vigilance will be more important with a balanced-budget target. This means that it is more important for fiscal policy to be in phase with the economic cycle – that there are surpluses during a boom and a balanced budget when the economy is normal.

NEGLIGIBLE LONG-TERM EMPLOYMENT EFFECTS FROM SWITCHING TO BALANCED-BUDGET TARGET

High employment is a fundamental objective of economic policy and is essential for funding an ambitious welfare commitment. It is therefore particularly important to analyse the long-term effects of economic policy on employment. In the long run, it can be assumed that employment will be affected mainly by the incentive to work and by the functioning of the labour market, in particular wage formation. There are no particular reasons to assume that the functioning of the labour market will be affected by the level of the budgetary target, but the presence of a credible fiscal policy target can favour employment by making the basis for wage formation predictable and stable. The incentive to work is determined in turn largely by the rules in the tax and transfer systems. How switching to a balanced-budget target will affect these systems will depend on how the medium-term space for spending increases and/or tax reductions is used. Some taxes have little effect on the incentive to work, such as environmental and property taxes. If it is mainly these taxes that are higher with a surplus target, the consequences for employment will probably be minor. There may also be positive employment effects from a surplus target in the long term. A surplus target means that there is more scope to counter an economic crisis with active fiscal policy. Especially large economic crises can impact negatively on employment as a result of those who lose their jobs struggling to find work after a long period of unemployment.

On balance, the NIER believes that the long-term level of employment will not be affected to any great degree by switching to a balanced-budget target.

MINOR SHORT-TERM GAINS FROM SWITCHING TO BALANCED-BUDGET TARGET SHOULD NOT DETERMINE CHOICE OF TARGET

Fiscal policy can also impact on employment in the short term through its effect on aggregate demand in the economy. Switching to a balanced-budget target will mean that the need for fiscal tightening that is there with either target will diminish over the coming five-year period. This will slightly benefit employment during the period relative to more stringent tightening. But this should not determine the choice of target. The fiscal tightening that occurs during an economic upturn is a mirror image of the expansionary policy pursued during the previous downturn. Fiscal tightening in an economic upturn is a key element of an ambitious stabilisation policy. The more ambitious the stabilisation policy, the greater the tightening needed once the economy improves. It goes without saying that it is not long-term sustainable to stimulate the economy in every downturn and then fail to tighten fiscal policy again when the economy recovers.

The NIER's calculations point to minor short-term employment gains from switching to a balanced-budget target. Unemployment can be expected to be 0.3 percentage points higher on average in 2016−2018 if fiscal policy is geared towards structural net lending of 1 per cent of GDP in 2018, as opposed to the NIER's June forecast showing that structural net lending will be zero in 2018. The negative employment effects will be exacerbated by the limited monetary policy leeway in the coming years. If the government finds it appropriate on the basis of long-term considerations to continue with a surplus target, it should not be put off by a temporary dip in employment. Attaching excessive importance to short-term employment effects in the choice of target could damage the target's credibility.

FLEXIBLE FORMULATION OF TARGET COMPLICATES EVALUATION

The surplus target was formulated as a target for net lending averaged over a business cycle in order to avoid procyclical active fiscal policy with tightening measures during a downturn. There are significant stabilisation policy gains to be had from a flexible formulation of this kind, but this flexibility makes it harder to assess performance against the target. The fundamental problem when following up a budgetary target over a business cycle is that the economic climate is hard to gauge. Uncertainty about the economic climate and flexible formulation of the target pave the way for varying interpretations of whether public finances are on track. This uncertainty means that calculations of structural net lending will also be subject to uncertainty, which can lead to undesirable policies if such indicators are used in isolation to follow up the target.

Recent years have seen disagreement between the government and the Swedish Fiscal Policy Council over whether public finances are in line with the target. It is an obvious disadvantage of the current evaluation model that a consensus cannot be reached on whether the target is being met. Consideration should therefore be given to enhancing the evaluation of the target.

PLANNING FOR FUTURE ADJUSTMENTS TO TARGET

When the surplus target was first introduced, it was not intended to apply indefinitely. There was, however, no clear plan for future revision of the target. This was unfortunate and will complicate any revisions in the coming years. There is a risk that revisions will be interpreted as being motivated by short-term gains, undermining the status of the target and the credibility of fiscal policy.

A constant budgetary target to apply forever more does not have any inherent value. The target will need to be adjusted in the event of demographic changes, for example, or new information showing that a different level would better support the fundamental objectives of fiscal policy. On the other hand, the target should not be revised too often. A target that is adjusted frequently loses credibility and cannot be followed up. It is, of course, impossible to state precisely how these two factors should be balanced, but the NIER believes that the budgetary target should not be changed more than once a decade. It is critical for the credibility of the target that revisions are made on the basis of the fundamental objectives of fiscal policy. It will always be tempting for the sitting government to lower the budgetary target, but there is a limit to how many times this can be done before finances become unsustainable. Fiscal credibility will not be served if the target is revised down to reap the short-term stabilisation policy gains that will always be available. Revising the target because it is hard to attain is also a weak argument.

These factors indicate that a system should be developed for future revisions of the target. Such a system should be predictable and have the broadest possible support in parliament. This would boost the credibility of the target and make it easier for consumers and firms to form expectations about future fiscal policy.