

SPECIAL ANALYSIS

The NIER's Assessment of the Scope for Reforms

The NIER defines the scope for reforms as the margin available in the central government budget for permanent unfunded measures in the latest five-year period. For the period 2013–2017 it is the NIER's assessment that the margin for new permanent unfunded measures is sharply limited. This is explained by the fact that fiscal policy has had an expansionary stance and should be tightened in the period ahead in order for net lending to be in line with the surplus target.

The concept of scope for reforms has been used frequently in the debate on the economy. However, as the concept lacks a clear definition, it tends to mean different things. The first part of this special analysis describes how the NIER defines the concept of scope for reforms and how it can be calculated. In the second part the NIER presents its assessment of the scope for reforms for 2013–2017.

The NIER's Definition of the Scope for Reforms

AUTOMATIC BUDGET REINFORCEMENT IN THE ABSENCE OF ACTIVE NEW POLITICAL DECISIONS

The Government's margin for implementing unfunded measures that weaken the budget is ultimately limited by the surplus target for general government finances. The surplus target provides that the net lending of the general government sector is to average 1 percent of GDP over an economic cycle.²¹ The design of the surplus target thus permits net lending to vary over an economic cycle (see the special analysis "The Surplus Target for General Government Finances"). This is also done normally, partly through the so-called automatic stabilizers,²² and partly through active fiscal policy decisions.

²¹ The magnitude of measures is also limited on the expenditure side by the ceiling on central government expenditure.

²² The development of public finances automatically weakens when the economy deteriorates. The principal reason is that tax revenues develop in proportion to various tax bases, which tend to stagnate or decrease in an economic downturn. At the same time, there is an increase in other expenditure – on unemployment, for instance.

The NIER calculates cyclically adjusted net lending as the net lending of the general government sector adjusted for the effects of automatic stabilizers. Cyclically adjusted net lending shows what net lending would have been if the economy had been in cyclical balance. Cyclically adjusted net lending is therefore a measure of the underlying level of the net lending in general government.²³ If cyclically adjusted net lending increases (decreases), this is taken to mean that the stance of fiscal policy is contractionary (expansionary).

With unchanged rules, that is, in the absence of active new political decisions, cyclically adjusted net lending increases over time, giving fiscal policy a contractionary stance.²⁴ This occurs because public expenditure normally increases more slowly than revenue with the economy in balance and with unchanged rules, which are ultimately determined by the set of rules that govern indexation of various items of government expenditure (see the fact box below on the NIER's method of calculating revenue and expenditure with unchanged rules). Since tax revenue increases at largely the same rate as potential GDP with the economy in balance and unchanged rules, the overall effect is an automatic strengthening of the budget, which is the mechanism that creates the scope for reforms. In the normal case, therefore, unfinanced measures must be implemented each year for cyclically adjusted net lending to remain unchanged and for fiscal policy to have a neutral stance.

With the design of the rules, however, the standard of service decreases if the rules remain unchanged, given the current demographic trend.²⁵ This decrease takes place through a lower standard of public services, for example in reduced staff intensity in health care, schools and nursing, as a consequence of nominally unchanged central government grants and unchanged local government tax rates. It also takes place through a decrease in disbursement levels per individual relative to the general level of earnings. Thus, the automatic budget reinforcement arises primarily as a consequence of a reduced standard-of-service commitment.

²³ Cyclically adjusted net lending is calculated as revenue with GDP at its potential level, normal composition of tax bases and actual implicit tax rates less actual expenditure with employment at its structural level. The Ministry of Finance calculates a similar measure termed structural saving.

²⁴ "Unchanged rules" means that revenue and expenditure are projected on the basis of the macroeconomic development and the set of rules currently in effect. See the fact box below on the NIER's method for calculating revenue and expenditure with unchanged rules.

²⁵ The standard-of-service commitment has not been constant over time, nor should it be. Political preferences and the development of society affect what is considered a desirable commitment. See the fact box below on the NIER's method for calculating primary expenditure with an unchanged standard-of-service commitment.

THE NIER'S DEFINITION OF THE SCOPE FOR REFORMS

The NIER defines the scope for reforms as the *permanently unfunded measures* in the central government budget for which there is room within the limits of the surplus target over a period of years. To enhance comparability over time (and with the calculations of the Ministry of Finance), the NIER has chosen to calculate the scope for reforms for the next five-year period.²⁶ The starting point for the calculation is the latest year for which there exists a budget bill. The current period covers the years 2013–2017.

It is difficult to specify a *scope for reforms* for individual years since the margin for unfunded measures in a particular budget bill depends on political considerations. The magnitude of these measures reflects both the need for an active fiscal policy and the need for future adjustments of net lending in order to meet the surplus target. A budget bill with a larger appropriation for unfunded measures in the first year means that the margin for unfunded measures will be somewhat less in subsequent budget bills, and vice versa. Thus, the scope for reforms does not indicate an amount in a particular budget.

MAGNITUDE OF SCOPE FOR REFORMS CALCULATED FROM CYCLICALLY ADJUSTED NET LENDING

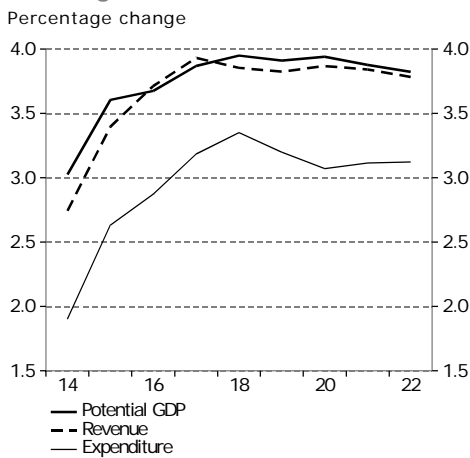
In calculating the scope for reforms, the NIER uses cyclically adjusted net lending as the starting point. The NIER interprets the surplus target as a forward-looking one. This means that net lending should be in line with the surplus target when the economy is in cyclical balance and the output gap is closed.

The magnitude of the scope for reforms depends partly on what cyclically adjusted net lending is considered compatible with the surplus target when the economy is in balance, and partly on what cyclically adjusted net lending is estimated to be at the end of the five-year period. The NIER's assessment is that cyclically adjusted net lending should be 1.2 percent of potential GDP when the economy is in cyclical balance, in order for net lending to be regarded as in line with the surplus target (see the special analysis "The Surplus Target for General Government Finances").²⁷

²⁶ The scope for reforms can be defined for another period. The longer the period, the greater the scope for reforms since the automatic budget reinforcements of several years will be added to it. For a period that is too short, on the other hand, it is not possible to specify a scope for reforms. There may be cyclical reasons for a temporary deviation of cyclically adjusted net lending from the target level. This makes it difficult to determine whether net lending is compatible with the surplus target during a period when the economy is not in balance.

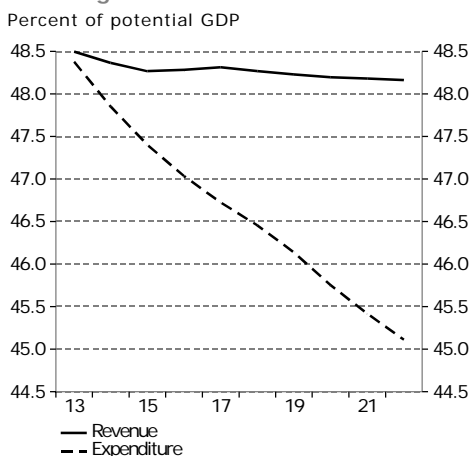
²⁷ The NIER has made a downward revision of the target level for cyclically adjusted net lending. Previously it was determined to be 1.5 percent of potential GDP (see the special analysis "The Surplus Target for General Government Finances").

Diagram 44 General Government Revenue and Expenditure with Unchanged Rules



Note. Development in a cyclically neutral state.
Source: NIER.

Diagram 45 General Government Revenue and Expenditure with Unchanged Rules



Note. Levels in a cyclically neutral state.
Source: NIER.

The scope for reforms can be calculated as the difference between cyclically adjusted net lending with unchanged rules in the final year and the target level of 1.2 percent. If, for example, cyclically adjusted net lending in the final year is estimated at 2.0 percent of potential GDP with unchanged rules, the scope for reforms during the immediately following five-year period will be equivalent to 0.8 percent of potential GDP.

SCOPE FOR REFORMS NOT AFFECTED BY RESOURCE UTILIZATION IN THE ECONOMY

Low resource utilization means that the automatic stabilizers will weaken net lending. This does not, however, entail any limitation of the scope for reforms since the low net lending is only temporary. When the economy enters an upturn and resource utilization is normalized, net lending improves again.

On the other hand, the scope for reforms is affected by the level of cyclically adjusted net lending at the outset of the five-year period. If fiscal policy has previously had an expansionary stance and cyclically adjusted net lending is less than 1.2 percent of potential GDP at the outset, fiscal policy must be gradually tightened for net lending to return to its long-term target level. This need not take place through active reductions in expenditure. If the deviation from the long-term target level is not overly large, the tightening can be achieved solely through reducing the amount of unfunded measures during a period.

DEVELOPMENT OF PUBLIC SECTOR EXPENDITURE CURTAILED BY DESIGN OF THE SET OF RULES

The automatic budget reinforcement arises because the primary expenditure of general government develops more slowly than the primary revenue with the economy in cyclical balance and with unchanged rules. The revenue of general government increases under these conditions at the same rate as the respective tax base, which in turn follows potential GDP relatively closely (see Diagram 44). The development of revenue with unchanged rules is therefore governed to a large extent by the forecast development of central macroeconomic variables in the longer term, such as potential productivity and structural employment, as well as the composition of demand and tax bases. Higher potential GDP growth in the economy, through higher potential productivity growth or more potential hours worked, leads to an increase in the scope for reforms.

With the current set of rules, the standard-of-service commitment decreases each year in the absence of active new decisions. The expenditure of general government then increases

more slowly than its revenue (see Diagram 44). Expenditure thus decreases as a share of potential GDP (see Diagram 45). This is so primarily because:

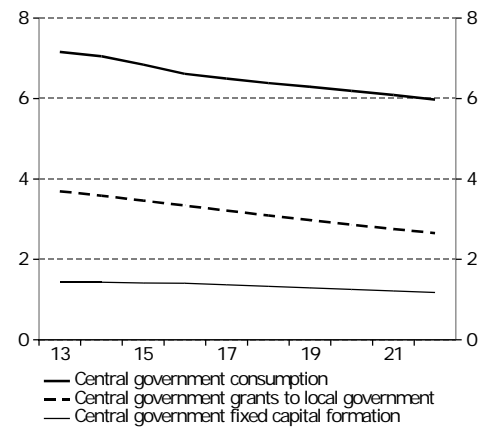
- The appropriations of central government authorities increase by a weighted factor for the development of prices and earnings (PLO), which is normally less than GDP growth in current prices (see Diagram 46).
- The plans for central government investment in infrastructure usually entail decreased expenditure for investment as a share of potential GDP (see Diagram 46).
- Central government grants to local governments are not regularly indexed; instead, changes are made by active decision (see Diagram 46).
- Several systems of transfers lack indexation of earnings. Individual allowance levels are revised upward in certain cases by the price-dependent base amount, such as study allowances, or in other cases are left unchanged in nominal terms, such as child allowances (see Diagram 47).
- Other transfer-based systems have set low ceilings which are not indexed; these systems include unemployment insurance and compensation for participation in labour-market programmes. This means that disbursements to most individuals covered by the system do not keep pace with the general progression of earnings (see Diagram 47).

In addition to the set of rules, various structural changes can affect the development of expenditure. One example is expenditure for sickness and activity compensation, which according to the National Social Insurance Agency is expected to continue decreasing as a share of potential GDP because fewer people will be receiving these benefits in the next few years (see Diagram 47).²⁸ The opposite case is the rising disbursements, in proportion to GDP, of the old-age pension system due to an increasing proportion of elderly persons in the population (see Diagram 48).

The scope for reforms is also affected by variations in the net interest expenditure of general government, via changed interest rates and/or changed indebtedness. Rising market interest rates on the debt of general government limit the scope for reforms.

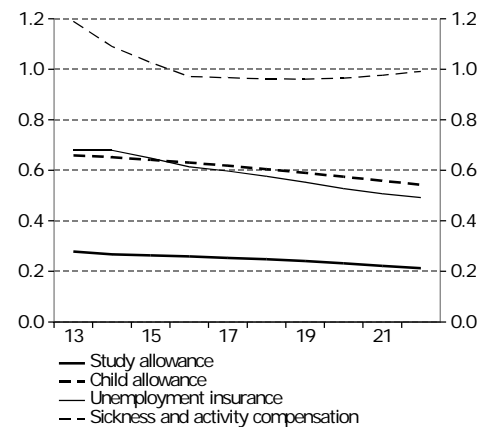
²⁸ Beginning with 2020, expenditure for persons with sickness and activity compensation will increase slightly in proportion to revenue.

Diagram 46 General Government Expenditure with Unchanged Rules
Percent of potential GDP



Note. Levels in a cyclically neutral state.
Source: NIER.

Diagram 47 General Government Expenditure with Unchanged Rules
Percent of potential GDP



Note. Levels in a cyclically neutral state.
Source: NIER.

Diagram 48 Old-age Pensions Payable
Percent of potential GDP



Note. Levels in a cyclically neutral state.
Source: NIER.

SOME FACTS

The NIER's method for calculating revenue and expenditure with unchanged rules

The NIER calculates the revenue and expenditure of general government with unchanged rules, that is, with the set of rules currently in force. Revenue is projected according to the development of the respective tax base and with unchanged implicit tax rates. Expenditure is projected with models that reflect the set of rules currently in force.

Central government consumption expenditure with unchanged rules will be based in the near future on the forecasts of the Government or the Swedish National Financial Management Authority. Thereafter, expenditure will be projected by an estimated price and earnings indexation factor (PLO) that provides the set of rules for indexation of appropriations. Adjustments are also made for temporary projects that are being terminated.

Central government investment expenditure with unchanged rules is based on the Government's investment plans for roads and railroads. These plans are used for projecting investment in buildings and structures. Investment in other types of capital is projected according to the CPI.

Central government transfers with unchanged rules are projected with the aid of models reflecting, at an aggregate level, the rules in the respective transfer system. Certain sets of rules contain no indexation of benefit levels. Expenditure for child allowances, for example, is projected according to the number of children aged 0–15, since changes in the child allowance requires political decisions. Other sets of rules are covered by low ceiling amounts that are not indexed, such as unemployment insurance. Expenditure for this purpose is projected only by the number of unemployed since an overwhelming share of individuals receive compensation on the same level as the ceiling. Still other transfer schemes have higher ceilings which are, in addition, indexed using the price base amount, such as the parental insurance system. These transfers are projected by the relevant age group, or other relevant group, and according to nominal hourly earnings

Central government grants to local governments with unchanged rules are assumed to remain the same in nominal terms. Local government consumption is calculated as the consumption expenditure for which there is a sufficient margin given an unchanged local government tax, nominally unchanged central government grants and the NIER's forecast for investment (which estimates local government investment at roughly 1.9 percent of potential GDP in the longer term).

Assessment of the scope for reforms

LIMITED SCOPE FOR REFORMS UP UNTIL 2017

Cyclically adjusted net lending with unchanged rules will amount to 1.0 percent of potential GDP in 2017, according to the NIER's forecast for the development of the macroeconomy.²⁹ This is lower than the level of 1.2 percent considered compatible with the surplus target in the longer term. The scope for reforms for 2014–2017 is thus –0.2 percent of potential GDP, equivalent to a saving need of SEK 8 billion.³⁰ One interpretation is that budget reinforcements on the revenue side are required in this amount in order to finance expenditure with unchanged rules and at the same time meet the need for greater fiscal austerity.

The contribution to the scope for reforms can be decomposed into contributions from automatic budget reinforcement, adjustment of fiscal policy to meet the surplus target and (net) changes in interest expenditure (see Table 14).

Table 14 Contributions to Scope for Reforms 2014–2017

SEK billion and percent of potential GDP, respectively

Automatic budget-strengthening given unchanged rules (1)	64	1.5
<i>Contribution from primary income</i>	264	
<i>Contribution from primary expenditure</i>	–200	
Adjustment of fiscal policy to the surplus target (2)	–60	–1.4
Net interests (3)	–12	–0.3
Scope for reforms (1+2+3)	–8	–0.2

Source: NIER.

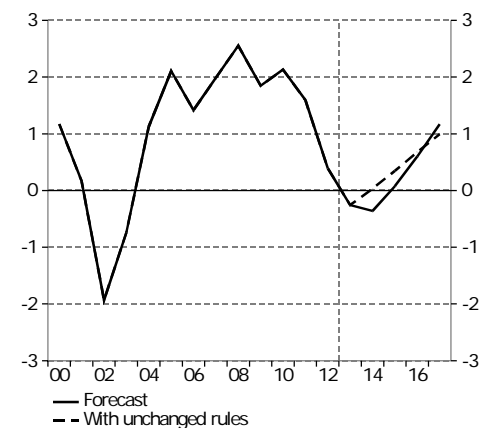
The automatic budget reinforcement arising when primary expenditure develops more slowly than primary revenue with unchanged rules is calculated to be SEK 64 billion. Fiscal policy

²⁹ The calculation of unchanged rules is based on the Budget Bill for 2013 and the average local government tax for 2013. The calculation is based on the assumption that no further unfunded measures are decided for 2013. In the event of such decisions, the scope for reforms 2014–2017 would decrease correspondingly.

³⁰ If the economic cycle were assumed to be symmetric in the future, cyclically adjusted net lending would need to be only 1.0 percent of potential GDP in the longer term in order for actual net lending to be compatible with the surplus target. The scope for reforms for 2013–2017 would then be close to SEK 0 billion.

Diagram 49 Cyclically Adjusted Net Lending

Percent of potential GDP



Source: NIER.

has had an expansionary stance for several years, and cyclically adjusted net lending will be only –0.3 percent of potential GDP in 2013 (see Diagram 49). In order for cyclically adjusted net lending to rise to 1.2 percent of potential GDP by 2017, fiscal austerity measures totalling SEK 60 billion will be required. In addition, increased costs of interest due to rising interest rates and a slightly higher public debt will reduce the scope for reforms by a further SEK 12 billion.

FINANCING NEEDS WITH AN UNCHANGED STANDARD-OF-SERVICE COMMITMENT³¹

The automatic budget reinforcement arises primarily from a reduced standard-of-service commitment. The NIER estimates that SEK 61 billion in central government measures would be required to maintain the standard-of-service in 2014–2017 (see Table 15 and the fact box below for more information on the NIER’s method for calculating primary expenditure with an unchanged standard-of-service commitment).³² The overwhelming majority of the measures are needed in order for central and local government consumption to keep pace with increasing demographic needs. The pressure on expenditure arises primarily from the growing proportion of children and elderly people in the population in the years to come (see the special analysis “The Surplus Target for General Government Finances”).

³¹ The term “an unchanged standard-of-service commitment” replaces the concept of “securing the real value of public expenditure” previously used by the NIER.

³² The calculation of expenditure with an unchanged standard-of-service commitment is based on the Budget Bill for 2013 and the level of various expenditure items that year.

Table 15 Total Change of Costs in Excess of Unchanged Rules 2014–2017 Given Maintained Public Sector Commitment

SEK billion and percent of potential GDP, respectively

Central government measures given maintained public sector commitment (1)	61	1.4
<i>Thereof central government consumption</i>	22	0.5
<i>Thereof central government grants to local government</i>	24	0.6
<i>Thereof central government fixed capital formation</i>	3	0.1
<i>Thereof central government transfers</i>	12	0.3
Local government financing need after increased central government grants (2)	5	0.1
Total change of costs for maintaining public sector commitment (1+2)	66	1.5
Scope for reforms (3)	-8	-0.2
Total financing need given maintained public sector commitment (1+2-3)	74	1.7

Source: NIER.

Even when central government grants keep pace with the increasing demographic need, there arises a local government financing need in order to keep a commitment within the limits of the balanced budget requirement for local governments. The reason is that given the average local government tax rate for 2013, the tax revenue of local governments will increase more slowly than consumption expenditure with an unchanged commitment. There will be a need to increase local government revenue further to about SEK 5 billion, equivalent to a higher local government tax of about 0.22 percentage points, in 2014–2017 in order for consumption expenditure to keep up with the growing demographic need. Without tax increases and with other revenue given, local governments will not be able to increase consumption at the same rate as the demographic need.

The aggregate cost of maintaining the commitment of the public sector is estimated at SEK 66 billion. Taken together with the need for a contractionary fiscal policy in order to meet the surplus target, there is a total financing need (through tax increases, for example) equivalent to SEK 74 billion.

SOME FACTS

The NIER's Method for Calculating Primary Expenditure with an Unchanged Standard-of-Service Commitment

The calculation of the primary expenditure of general government with an unchanged standard of service is based primarily

on the development of the population in different age groups and on nominal hourly earnings.

Central and local government consumption expenditure with an unchanged standard of service are projected by the demographically determined demand for different types of public services. The method reflects unchanged staff intensity in public services. The demographically determined development of consumption will accelerate when the number of children and elderly individuals increases in relation to persons of working age, since the average cost of health care, nursing and other care for the elderly and for children is relatively high.

Central government grants to local governments are projected by demographically determined demand. Central government grants then constitute a fixed share of local government consumption.

Central and local government investment expenditure with an unchanged standard-of-service commitment is projected by the development of potential GDP in current prices.

Central government transfers with no change in the standard-of-service commitment are projected according to the population in the relevant age group or some other group and by nominal hourly earnings. Thus, the level of subsidies and expenditure per individual are held constant in relation to nominal earnings, which means that the benefits provided by the systems of transfers will maintain their relative purchasing power (unchanged replacement rate).