Special Analysis

Automatic fiscal tightening provides scope for unfunded measures

In the absence of active fiscal policy, public finances will strengthen over time. This "automatic fiscal tightening" occurs because, without active fiscal measures, revenue will tend to grow with the economy, while spending will generally fall as a share of GDP. This normally generates fiscal space. Our estimates show fiscal space of around SEK 100 billion in the period from 2021 to 2023.[15] Given the macroeconomic scenario we present, it will therefore be possible to introduce unfunded measures (such as tax cuts and spending increases) of this magnitude over the same period while keeping structural net lending in line with the surplus target. This special analysis explains why this automatic fiscal tightening arises and how it normally results in fiscal space.

Our fiscal scenario assumes active fiscal policy to maintain personnel density in the provision of publicly funded services at 2020 levels plus an annual increase in standards corresponding to 0.4 per cent. This assumption differs from the government's calculations, which are based on current rules and measures announced in the latest budget bill.

Alongside this fiscal scenario, we also perform calculations that do not include any fiscal measures beyond those set out in the latest budget bill and relating to the fiscal year in question. This alternative approach is referred to as "unchanged rules" and is more comparable with the government's forecasts.[16] With unchanged rules, there will be automatic fiscal tightening over time that generates fiscal space.

How does automatic fiscal tightening arise?

With unchanged rules, revenue will move roughly in line with nominal GDP over time. A few taxes, such as the duties on

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[15] The fiscal space presented in our June report was slightly higher. The difference is due mainly to the June estimate referring to the period from 2020 to 2023, whereas the new estimate covers only the period from 2021 to 2023.

[16] The NIER's calculations with unchanged rules do not include announcements in the latest budget bill relating to fiscal years after the coming one. This differs from the approach taken by the government and the Swedish National Financial Management Authority (ESV), which both include measures announced for subsequent years in their calculations.

alcohol and tobacco, are set in nominal terms, which means that revenue from them will gradually decrease as a share of GDP. The majority of taxes, however, are directly linked to a tax base. Large tax bases such as consumption and labour income move more or less with GDP over time, and so total tax revenue will grow in line with GDP with unchanged rules. Spending, on the other hand, does not have a direct link to economic growth. For expenditure not to fall as a share of GDP, active policy measures will normally be required. Diagram 41 shows how revenue and expenditure move with unchanged rules in our current forecast. Expenditure drops from around 49 per cent of GDP in 2020 to around 46 per cent in 2023, whereas revenue is relatively stable as a share of GDP.

RULES FOR CENTRAL GOVERNMENT EXPENDITURE EXPLAIN WHY SPENDING RISES MORE SLOWLY THAN GDP

When we estimate automatic fiscal tightening, the starting point is the various rules that govern central government expenditure. The decline in spending as a share of GDP with unchanged rules is a result of how the different types of expenditure rise each year in the absence of active policy measures from the government or parliament. Central government expenditure can be divided into three types: nominally determined, rule-based and institutional. *Nominally determined expenditure* is dominated by general grants to the local government sector, which are set in nominal terms and are not therefore linked in any way to GDP growth. With unchanged rules, we assume that this expenditure will stay at the level proposed in the government's latest budget bill.[17] *Rule-based expenditure* consists primarily of transfer payments to households. Most transfers move partly with changes in volume (number of recipients) but also with changes in prices, as some benefits are linked to inflation. Even with unchanged volumes, this expenditure will therefore increase somewhat each year, but it will decrease as a share of GDP over time because nominal GDP generally rises more quickly than prices.[18] *Institutional expenditure* rises each year on the basis of an annual "PLO adjustment", which is reflects movements in prices and wages but also includes a deduction for productivity growth. This expenditure therefore normally rises more slowly than nominal

[17] This assumption differs from the government's method, where nominal changes to general grants to local government are included in the calculations once announced even if not yet approved. This currently means that general grants to local government increase slightly in 2021 and 2022 in the government's forecast, but hold at 2020 levels in the NIER's forecast with unchanged rules.
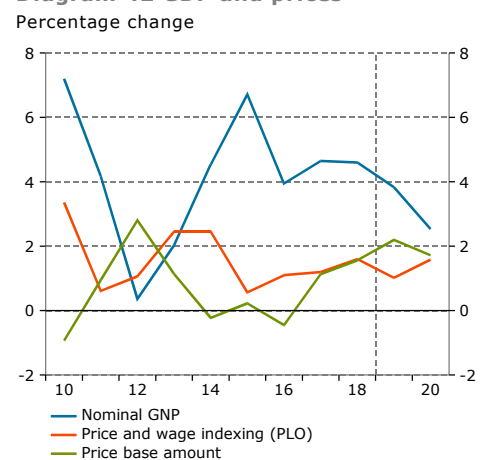
[18] Nominal GDP growth is the sum of growth in real GDP (i.e. volume changes) and the GDP deflator (i.e. price changes).

Diagram 41 Government expenditure and revenue with unchanged rules after 2020
Per cent of GDP
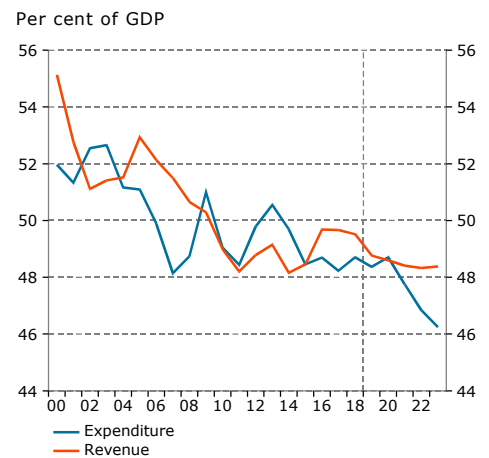
Source: NIER.

Diagram 42 GDP and prices
Percentage change

Sources: Statistics Sweden and NIER.

GDP (see Diagram 42).[19] It is mainly funding for central government institutions that follows the PLO system.

"GOOD FINANCIAL MANAGEMENT" ASSUMED IN THE LOCAL GOVERNMENT SECTOR

Expenditure at municipalities and county councils depends largely on developments in the size and composition of the population. Unlike in the central government sector, there are no specific rules on spending. Instead, the local government sector is governed by a balanced-budget requirement and an expectation of "good financial management" (see box "Good financial management"). Exactly as in our fiscal scenario, the local government sector as a whole is assumed to meet the expectation of good financial management with unchanged rules. The NIER's operationalisation of good financial management corresponds to net lending in the longer term (currently 2024) reaching -0.3 per cent of GDP.

Since the rate of municipal taxation is assumed to be unchanged at 2020 levels with unchanged rules, tax revenue will rise largely with GDP. Central government grants to the local government sector are also assumed to be unchanged in nominal terms, which means that local government revenue as a whole will decrease as a share of GDP over time. To meet the expectation of good financial management, the local government sector must therefore adjust its spending. At present, the sector's net lending is below the level that we consider to be consistent with good financial management in the longer term (see Diagram 43). Significant tightening will be needed to achieve net lending of -0.3 per cent. This means that expenditure (which consists mainly of consumption) falls as a share of GDP with unchanged rules. This tightening means that consumption does not rise with the demographic need, with the result that personnel density in the provision of public services decreases over time.

Automatic fiscal tightening normally generates fiscal space

Under Sweden's fiscal policy framework, general government net lending shall average one-third of a percent of GDP over a business cycle. To gauge compliance with this surplus target,

Good financial management

The Swedish Local Government Act requires municipalities and county councils to meet a balanced-budget requirement and practise good financial management. The *balance-budget requirement* means that municipalities and county councils are not permitted to budget spending in excess of revenue without a special reason. The expectation of *good financial management* is not quantified: it is left to each municipality and county council to make its own interpretation. The Swedish Association of Local Authorities and Regions developed a rule of thumb in 2005 to assist municipalities and county councils in their planning. This rule of thumb is that an authority's surplus should be 2 per cent of taxes and general grants from central government. Depending on the local starting point and other local factors, this level may be either higher or lower.

The NIER's operationalisation of *good financial management* for the local government sector as a whole is net financial wealth that is stable over time as a share of GDP. At present, this is considered to be equivalent to net lending of -0.3 per cent of GDP. This corresponds to a net income of around 4 per cent of taxes and general grants from central government.

Diagram 43 Net lending in local government
Per cent of GDP
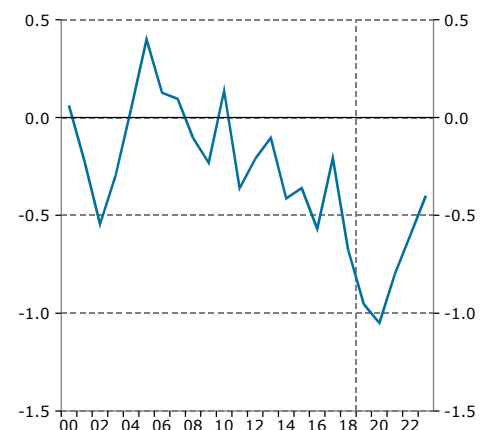
Sources: Statistics Sweden and NIER.

[19] The PLO system aims to compensate central government institutions for increases in prices, adjusted for an efficiency and productivity requirement, also known as a productivity deduction. This deduction is calculated to correspond to a ten-year average of productivity growth in the private service sector.

structural net lending – net lending adjusted for cyclical effects – is used as an indicator. The automatic fiscal tightening due to government spending rising more slowly than GDP means that structural net lending improves over time. If net lending exceeds one-third of a percent of potential GDP[20] with unchanged rules, there is considered to be fiscal space – i.e. scope for unfunded measures. The size of this fiscal space corresponds to the difference between structural net lending with unchanged rules and one-third of a percent of potential GDP (see Diagram 44). Estimates of structural net lending and fiscal space are associated with considerable uncertainty.[21]

How does the NIER's method differ from that of the government?

The method that the government uses to calculate automatic fiscal tightening is in many respects similar to the NIER's method. The main difference lies in the interpretation of what level of local government net lending is consistent with good financial management. While we look at local government net lending and take the view that it should be -0.3 per cent of GDP in the longer term, the government method presumes that the local government sector generates a net income at the end of the forecast horizon of 2 per cent of taxes and general grants from central government. At present, there is a considerable gap between the local government sector's net income and its net lending. This is explained mainly by the sector's increased levels of investment since the 2000s impacting directly on net lending but having only a minor effect on current net income via depreciation. The differing assumptions made by the NIER and the government on the target level for local government net lending mean that the sector needs to save more in our scenario. All else equal, this means a higher level of automatic fiscal tightening – and so more fiscal space – in our scenario.

However, there are also other factors that affect fiscal space, such as the estimate of current structural net lending. In the forecast presented by the government in its budget bill for 2020, structural net lending (in per cent of potential GDP) next year is around 0.2 percentage points higher than estimated by the NIER. All else equal, this means more fiscal space. The difference in structural net lending is due primarily to different views on actual net lending.

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[20] Potential GDP is the output level with the economy operating exactly at capacity, i.e. with neither a positive nor a negative output gap.

[21] See the special analysis "Strukturellt sparande – en osäker bedömning" [Structural net lending – an uncertain quantity] in the Swedish version of *The Swedish Economy*, June 2019.

Diagram 44 Stuctural net ledning with unchanged rules and fiscal space
SEK billion

— Surplus target (1/3 per cent of potential GDP)
— Structural net lending, unchanged ruels
— Accumulated fiscal space (dashed area)
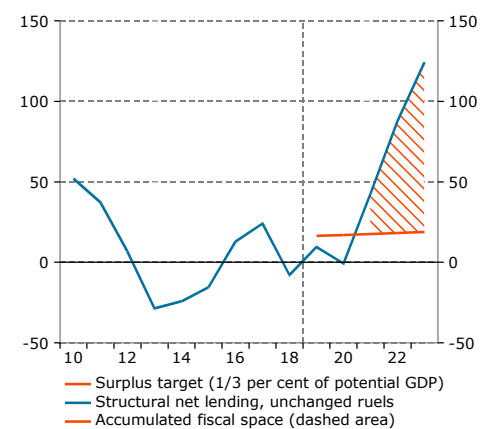
Note. The fiscal space refers to the entire general government.
Sources: Statistics Sweden and NIER.