

Focus: Swedish Spring budget bill



April 15, 2004

Neither growth-promoting nor countercyclical

The Spring Fiscal Policy Bill submitted to the Riksdag (Parliament) today is characterised by passivity. Measures to improve the long-term growth capacity of the Swedish economy are conspicuously missing – despite the strong prioritisation of growth promised in the Government Policy Statement last year. The government is instead now focusing its ambitions on pushing down unemployment with traditional Social Democratic countercyclical policies, such as larger grants to local governments. This spending is actually small, however, and will only have a marginal impact. Sweden's public surplus target is still a restriction on fiscal policy – although the budget balance is slowly drifting further from its target and budget discipline is gradually eroding. With blocked countercyclical policies and growth policy stopped by ideological doubts, economic policy will be watered-down.

Restructuring policy has turned into temporary stimuli

Last autumn's policy statement by the Social Democratic (SDP) minority government focused on long-term growth issues. It said that better conditions for enterprise and increased labour supply were key issues in responding to the pressures of an ageing population on social welfare systems.

But these words have faded into oblivion. The Spring budget does not give any answers at all regarding long-term tax strategy. However, it seems as though a corporate tax cut is no longer on the agenda. Any future cuts of the wealth tax will be financed by raising other taxes, whose growth effects are dubious. Prime Minister Göran Persson's thoughts about boosting social insurance co-payments have evaporated, instead the government now wants to raise benefit levels. The only important growth-promoting measures actually remaining are new "3:12" rules governing taxation of dividends and capital gains in closely held companies, plus general pledges on better educational policies.

The government has apparently switched to more traditional SDP pump-priming, in which **temporary demand stimuli** aim at reducing unemployment in the short term. The question is why such a significant shift from last autumn's growth rhetoric could occur. Here is our assessment:

- Sweden's No vote in the euro referendum and the recent upturn in unemployment have strengthened more traditionalist Social Democratic forces, pressuring the government to revert to its old remedies.
- This change of tack greatly facilitates the government's parliamentary alliance with the Green Party and Left Party. Apparently the government has assigned this alliance higher priority than a more favourable climate for the business community.
- A more far-reaching political interpretation is possible, based on a radio interview with Mr Persson last week. He played down the importance of the SDP's April 16-18 "intermediate congress" on economic growth, declaring instead that social welfare and redistribution issues are the soul of Swedish social democracy. He also spoke of a general leftward current in the world and said that this benefited social democracy.

Our conclusion is that the government's reorientation is due to political reasons. The **political pendulum** – inside and outside the SDP – has swung in a direction unfavourable to a long-term growth promotion policy.

Emil and his lemonade

This development undoubtedly raises the question of when, in that case, is the right time to deal with long-term restructuring issues. In good

times, growth problems are concealed – growth-promoting and restructuring measures are regarded as unnecessary. In bad times, the focus is instead on countercyclical policies.

This reminds us of the Swedish children's book character Emil in Lönneberga and his frustration at never getting his lemonade. At the auction in Backhorva, Emil exclaims: "When I *don't* have money, I *can't* drink lemonade, and when I *have* money, I'm *not allowed* to drink lemonade, so when on earth will I drink lemonade?"

Göran Persson himself has said that his favourite character in Astrid Lindgren's books is Emil's stern father. So perhaps it is perfectly logical that he should refuse to let Mother Svea imbibe any growth-promoting lemonade.

From all indications, the extra SDP congress will not lead to major rethinking of economic growth issues. The printed matter sent out in preparation for the congress is couched in extremely general terms and lacks specific proposals.

Yet the situation is not entirely gloomy. All else aside, the congress will make growth issues more politically acceptable to the SDP's grassroots. Party leaders will get its mandate to present at least some growth-promoting measures in the future. We expect some concrete **tax proposals** to be unveiled later this year.

The wealth tax will eventually be lowered. And the "fourth step" to compensate households for higher employee payroll fees (imposed due to the mid-1990s pension reform) will lead to somewhat lower marginal tax effects for low income earners.

Not very countercyclical either...

Although the government's spring budget bill focuses on temporary demand stimulation to combat unemployment, these measures are on a relatively small scale:

- "Labour market policy" programmes (government-financed temporary jobs and employment training) will be expanded by about 15,000 people during 2004, or 0.3 per cent of the labour force.
- A tax deduction for residential repairs, renovations and extensions will be re-introduced during April 14-June 30, at a cost of SEK 2.4 billion. Tax deductions for environmentally related investments also go

into effect on January 1, 2005 and will cost more than SEK 2 billion.

- Subsidies for hiring the chronically unemployed and the addition of new preschool teachers will cost SEK 2.5 billion in 2005 and another SEK 1 billion in 2006.
- Grants to local governments will be raised by about SEK 4 billion starting in 2005 and another SEK 3 billion in 2006.

The stimuli provided by the proposals in the spring budget are modest: about SEK 3 billion in 2004 and another SEK 5 billion in 2005, according to our projections. This is equivalent to 0.1-0.2 per cent of GDP per year.

Assessments of the overall effect of fiscal policy on the economy, taking all changes into account, instead point towards a **slight tightening**.

One reason is that the proposed extra aid to local governments is substantially less than it has been in recent years. State grants to local governments are nominally determined and do not rise automatically. The proposed increase only means that the grants will grow at the pace of other tax bases and thus not create any real room for higher local government consumption.

Another example is labour market policy, where new programmes are being proposed – after the cutbacks of 2003 and early 2004. Measured in annual averages, these programmes will still shrink between 2003 and 2004.

Budget target eroding but still the norm

Two factors explain why a policy of stimulating the economy via the budget is more words than action.

Firstly, Sweden has a **floating exchange rate**. The Riksbank is thus responsible for stabilisation policy. Secondly, the expenditure ceilings and the target of a public sector **budget surplus of 2 per cent of GDP** over an economic cycle still impose a restriction.

In spite of this, fiscal policy norms are steadily being eroded. According to our estimates, public financial savings will be negative this year and less than 0.5 per cent of GDP in 2005. Only part of this disparity can be explained by cyclical weakness. The fact that structural savings are about 1 percentage point below target indicates that the **government will not meet its budget target**.

According to our calculations, the annual state budget **expenditure ceilings** also risk being breached. The government will partly circumvent these problems by technically designating some of its aid to local governments as lower expenditures. Also, some 25 billion for infrastructure investments will be financed outside the budget during the next few years. In spite of this, rather large-scale cuts, on a scale of SEK 10 billion, will be required in order to keep the expenditure ceilings intact. Virtually the

entire budgeting margin for 2005 is also already booked up.

The spring budget bill provides no indication that the government is prepared for genuine austerity measures. There is consequently a major risk that the methods being used to keep expenditures below the ceilings will increasingly deviate from the original intentions, and that **budget discipline will thus decay further.**

Forecasts, public finances		
	2004	2005
Public sector financial savings, % of GDP		
SEB	-0.1	0.2
Spring budget bill	0.3	0.6
Central government borrowing requirement, SEK billion		
SEB	68	49
Spring budget bill	62	36
Margin beneath the expenditure ceiling, SEK billion (minus means breaching the ceiling)		
SEB	-10	0
Spring budget bill	0.1	1.6

Concluding comments

With his Spring Fiscal Policy Bill, Finance Minister Bosse Ringholm is introducing his weakest budget bill since taking office five years ago. His chances of pursuing a countercyclical policy are, of course, restricted by Sweden's floating exchange rate and budget targets. But it is striking that the Spring budget, contrary to the pledges in the government policy statement, so

manifestly lacks a long-term growth strategy – while budget discipline gradually crumbles, compared to the established targets and rules.

Economic policy seems to be stuck in an intermediate, watered-down position, in which necessary prioritisations are conspicuously absent.

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