

REFORMING BUDGETARY INSTITUTIONS: SWEDISH EXPERIENCES

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INTRODUCTION

During the last couple of decades, many OECD countries have accumulated a large public debt. There is considerable variation within the OECD group, however. Facing these differences between otherwise similar countries, it is natural to ask why some countries have been more seriously affected than others by the financial strain on central government. The present discussion deals with this question, and with the implications for national policy-making and institutional design of the answers that have been proposed.

In an orthodox ricardian perspective, public debt is not a problem. Behind the reform work to be described here lies the conviction that at least a large public debt is a cause for concern, and this point of departure will be taken for granted.

There is general consensus that the answers to the above questions cannot be found by studying the economic system in isolation. Any credible model of explanation must take into account the interaction between the economy at large and the political system. In a comprehensive survey of the economic literature on the subject, Alesina & Perotti (1995) list a number of approaches to the deficit problem that have been put forward in the literature. Some models, relying on basical economic variables, focus on the dilemmas facing any policy-maker or group of policy-makers in the area of public finance - divergence between sectoral or local and collective interests, intertemporal trade-off problems, and incomplete information. Other models, with a distinctly political focus, concentrate on the interplay between politicians and voters with incomplete information, or between politicians adhering to different policies. A third group of papers highlights differences in the institutional setting of financial policy-making, searching for key factors in the constitution or other parts of the regulatory framework that may be important to the outcome. The survey is by no means exhaustive; classical political science literature contains a wealth of empirical material on differences in political culture, sociology of power networks, and other aspects of government that are relevant to policy formation.

The view underlying the reform work presented here is that these different approaches are useful complements rather than substitutes. The basic problems of financial policy-making represent fundamental dilemmas, which can be more or less accurately rendered using game models, intertemporal allocation models, or combinations between the two. But this is only a first step. Societies have developed institutions in order to cope with these dilemmas, and some designs can be expected to be more efficient than others, or to represent different trade-offs between the various components of social welfare. Empirical evidence is obviously critically important to the discussion on institutional design, but so is the theoretical literature in order to gain a deeper understanding of the problems at hand.

Nonetheless, it is obvious that the third group of analyses, focusing on institutions, is the most immediately relevant in a reform perspective. A rich empirical literature is devoted to the connections between institutions and outcomes of the policy-making process. Some research deals with the fundamentals of the political system, such as the voting system (Grilli & al. 1991), others with party structure or average tenure of government or other parameters (Roubini & Sachs 1989), which is to a considerable extent contingent on the voting system. An increasing literature has focused on lower strata of the regulatory hierarchy governing public financial decision-making - the budget process in a more narrow sense. Evidence from Europe (von Hagen 1992, de Haan et al. 1992, von Hagen & Hardin 1994), the United States (Poterba 1993), and Latin America (Stein & al. 1997) testifies of the importance of budgetary rules to outcomes as measured by deficit or debt ratios.

Part of this accumulated experience was used in an effort to reform central-government budgetary institutions in Sweden, starting in 1992. This was done in the middle of a severe financial crisis, during which the country developed historically and internationally exceptional deficits. In what follows, we will describe in some detail what changes took place, and discuss the reasons for the relative success of the reform venture. Section 2 scans the literature and comments on some of the general hypotheses that have been proposed. The following sections describes in some detail what changes took place and why. In section 4 finally, we elaborate on the conditions that made change possible at the time.

FUNDAMENTAL PROBLEMS OF FINANCIAL POLICY MAKING

Problems

In the area of public budgeting, an efficient decision procedure is one in which the costs and benefits of a public undertaking are traded fairly against one another. It is further one in which decisions on expenditures and revenues are based on information that is accurate enough for decision makers to be able to make conscious choices on public sector financial saving - whether guided by balance

requirements, a golden rule requirement or other types of targets. Finally, credible projections not only of immediate but also of distant future costs and benefits are a prerequisite for balanced decisions. These requirements are far from always met.

Fiscal illusion

The first problem, normally referred to as *fiscal illusion*, stems from the asymmetric character of information about costs and benefits (Buchanan & Wagner 1977). Benefits associated with a particular undertaking are often clearly visible and more or less immediate. Costs, on the other hand, are more or less concealed, and are often incurred with a time lag. Even if budgetary expenditures are possible to estimate with some accuracy, the excess burden of taxation is difficult to calculate, and when it is possible, there is a non-trivial problem of conveying to decision makers the origin and character of this cost. Taken together, these asymmetries tend to bias the description of costs and benefits, favouring over-spending. This conclusion need not be based on public-choice type assumptions about disproportionately powerful interest groups, regulatory capture, and the like. In the presence of such distortions, bias will of course be even stronger.

Deficit bias

A related problem appears under the heading of *deficit bias*. Estimates of expenditures and revenues associated with a particular decision are necessarily uncertain, as they depend on behavioral assumptions. Second- and higher-order effects are notoriously difficult to appreciate, and experience shows that dynamic effects are on the whole underestimated. Given that tax bases tend to evade taxation, whereas beneficiaries tend to be attracted to expenditure programs, this incompleteness with respect to dynamic effects is a potential source of deficits. Again, this bias is inherent to the problem and therefore fully compatible with the notion of benevolent and well informed decision makers. Deviations from this classical assumption will tend to aggravate the problem. For instance, the analysis of Kneebone & MacKenzie (this volume) establishes that there is systematic bias in the perception of decision makers that tends to create a rosy picture of economic reality.

The two problems of fiscal illusion and deficit bias are interrelated. They both stem from incomplete knowledge, and the asymmetric nature of this incompleteness. Fiscal illusion is liable to generate deficit problems; vice versa, sustained deficits will increase the financial burden of central government via additional interest payments.

Myopia

A different, but related, problem of public decision making is connected with time horizons. Normal discounting of cost and benefit flows assumes an infinite time horizon, but politically relevant time horizons are most often very far from infinite. In view of the asymmetries referred to above, the mismatch between analytical and political time frames is yet another potential source of over-spending and deficits. The connection between average government tenure and deficit problems is statistically significant (Roubini & Sachs 1989), but the general caveats apply when it comes to measuring average tenure in a meaningful way. The longevity of governments in turn depends on institutional parameters such as the voting system (with the number of parties in parliament as an intermediate variable) and the mandate period.

A limited time horizon may affect political decision makers in different ways. The risk of replacement is an obviously important parameter, and governments' position could also play a role (Persson & Svensson (1989), Alesina & Tabellini (1990)). The long perspective of intergenerational distribution is also relevant to the deficit policy chosen (see e.g. Cukierman & Meltzer 1989).

Among these parameters, the mandate period and possibly the voting system can be considered as candidates for reform consideration. Franzese (this volume) indicates a strong long-term effect of changes in mandate period.

Budget constraints versus entitlements

An entirely different source of problems lies in the nature of public expenditure. A relatively large fraction of public expenditures, typically between 60 and 70 per cent of the budget in OECD countries, is non-negotiable in the short-run. The bulk of these expenditures is bound by legislation, for instance in the area of social security. A smaller but important fraction is tied by legal obligations of a different character; typical examples are interest on central government debt and commercial guarantees. The state simply cannot retreat from such obligations without incurring complete loss of credibility and substantial costs, political as well as financial.

By consequence, a binding budget constraint on the entire expenditure cake, or a slice thereof, is inadequate as a means of imposing restrictions on public spending. A simple cash limit on, for instance, an appropriation for child allowances or pensions is not a viable alternative.

In some contexts, for instance the budgetary framework of the European Union, the different categories are termed "mandatory" versus "non-mandatory" expenditures. This dichotomy is too simple, however; the inertia of expenditures varies more continuously, and may be more or less dependent on discretionary decisions by administrators in charge of a given system. A child allowance is completely bound

by the legislative framework, in the sense that it prescribes a certain sum per month to be paid out (normally to the mother in question). Who qualifies for this allowance is obviously not open to discussion. An unemployment support, on the contrary, has a number of qualifications attached to it, such as what kind of alternative employment the applicant can be required to accept, what distances of commuting are reasonable, etcetera. This calls for a number of discretionary decisions by the administrating agency, and consequently lends some flexibility to the implementation. Other types of expenditures, such as regional support systems or industrial subsidies, normally gives the agency in charge even more freedom of action.

By consequence, it seems more relevant to differentiate various expenditure systems with respect to their *inertia* or *time constants*. Characteristic time-constants depend on a lot of factors, material as well as administrative. A crucial point is whether the governing rules are laid down in detail in a law or just outlined, the details being specified in a government decree or ordinance. In the latter case, rules can be changed by simple government decision, which speeds up the process substantially.

Coping with the problems

Maintaining collective rationality

The decision dilemmas sketched above stem from conflicting objectives among decision makers. Conflicts may arise between individual and collective rationality (prisoners´dilemma type), between long- and short-term objectives, or simply between different political priorities. There is strictly speaking no solution to these dilemmas; what institutional economics can offer is examples of solutions that tend to promote collective rationality, long-term perspectives, and respect of budget restrictions. They achieve this in different ways, for instance by changing incentives, or by reminding of budget restrictions, or by arranging decision procedures in a way that forces the decision makers affected to recognize the essentially collective nature of the dilemma.

A central choice of design is how much coercion to build into the regulatory framework. In some countries, formal veto rights or blocking power play a central role in an attempt to maintain the desirable norms of behaviour, whereas other administrative traditions rely more on delegation of power and *ex post* control. The Nordic countries belong to the latter group.

One possibility of modifying *incentives* in the area of budgeting is to make proposals that aim at benefiting a particular group less attractive. An important example is a requirement that counter-proposals to the budget presented in parliament be offsetting. There is some empirical support for the effects of *group size* in the budgeting area, which may be a direct effect (diffusion of responsibility)

or indirect, via the intermediation of changing incentives. Hall & Grofman (1990), in a study on parliamentary committees, conclude that fewer committees in parliament, with correspondingly larger domains of responsibility, tend to reduce the influence of interest groups and thereby enhances discipline. There is also a possibility that the number of spending ministers in cabinet may affect fiscal discipline within the cabinet circle (Kontopoulos & Perotti 1997), but such an effect, if observed, may have simpler explanations.

Respect for *norms promoting collective rationality* is enhanced by making decisions in situations where social pressure is maintained by physical proximity. In the cabinet circle, the sense of collective responsibility for the choices made is strengthened by forcing the cabinet group to make a simultaneous, comprehensive decision on the basic parameters of the budget policy on one particular occasion. This procedure has been used since the seventies in Norway, and is now established also in Sweden.

Similarly, the way budget decisions are organized in parliament can be expected to affect the degree of responsibility towards general budget constraints. Examples of divisions of responsibilities and subprocedures that can be expected to forward the collective interest are a coordinating role for the finance committee, and a comprehensive budget decision early in the parliamentary budget process. There is some dispute concerning the latter point; whereas budget officials normally seem to be united on the superiority (in the disciplinary sense) of a top-down versus a bottom-up approach (see e.g. OECD 1996), Ferejohn & Krehbiel (1987) and Helland & Rasch (1996) question the validity of this thesis. Our own experience is that the answer may be somewhat context dependent, but that conventional wisdom normally is correct, in particular in times of crisis (when the budget process is put on trial). It seems quite obvious, for instance, that much of the recent budget consolidation activities in European countries - Sweden and others - would not have been accomplished without the aid of a top-down procedure supported by the Maastricht convergence criteria. In Sweden, these criteria were used operatively in cabinet negotiations when preparing the first tri-annual expenditure ceiling for 1997-99, and also played a central role in the mass media economic debate.

The pertinence of *information* to the promotion of budgetary discipline is illustrated in the literature on *transparency* of budget documents. A number of tricks can be used to hide relative over-spending within a particular sector, such as extra-budgetary funds, or netting expenditures against revenues, or simply by providing information that is difficult to penetrate for non-specialists, such as the average M.P. By consequence, budgetary discipline is enhanced by requirements on completeness of the budget, gross budgeting, and lucid presentation.

Rules giving a coordinating role to the finance committee in parliament or to the minister of finance guarantee that a certain weight is given to budgetary restrictions at the macro level, but say nothing about the decisions eventually taken or even

about the relative strength of the different parties to the decision. The system becomes more coercive if a *formal veto right* assigned to the minister of finance. Binding legislation of the type exemplified by the Gramm-Rudman-Hollings act also represents an attempt at coercing actors into cooperative behaviour. As the American experience illustrates, this type of constraint is difficult to manage in practice. Apart from the constitutional problems arising from conflicts between entitlement legislation and hard budget constraints, there remains some arbitrariness about the parameters necessary for this type of constraints - whether it be a bound on the annual deficit, or the government debt, or any other relevant number (Buiter et al. 1993).

A main drawback about coercive solutions is also that they tend to generate innovative activities aiming at disarming them, such as creative book-keeping, or concealing of strategic information. The handling of the convergence criteria associated with the formation of the EMU provides examples of such unproductive activities. Our conclusion, like that of Alesina & Perotti (1996), is that balanced-budget laws are neither necessary nor sufficient to ensure fiscal discipline.

Pressure from outside may help. The Maastricht convergence process has already been mentioned; elsewhere, the International Monetary Fund or simply the international financial markets may play the role of watchdog. Again, this type of pressure runs the risk of being equated with coercion and elicit attempts to circumvent it rather than to internalize it.

Stretching the time horizon

The *time horizon* is of central importance to both group interaction and individual decision making. In the area of financial policy, the importance of the average time horizon was demonstrated early (Roubini & Sachs 1989, Grilli et al. 1991). This parameter affected by basic institutions both directly, via the parliamentary mandate period, and indirectly, via the average longevity of cabinets, which in turn depends on *inter alia* the voting system and the resulting degree of parliamentary fragmentation.

Most countries use some type of multi-annual plans to support decision in budgetary matters. In the majority of countries, these plans are only indicative, and the corresponding information is supplied together with annual budget documents without further commitment. Exceptions to this rule are the UK and the Netherlands, where the multi-annual expenditure ceiling represents a high degree of political commitment, and Sweden following the recent reform, where the expenditure ceiling is binding.

The study by von Hagen (1992) questions the importance of the multi-annual components in the budgeting system; we will return to this problem below.

Handling entitlements and other obligations

As indicated above, the potential conflict between obligations on the part of state and budget constraints cannot be adequately handled by imposing a hard cash limit on the appropriations associated with the expenditures in question. In many countries, the budget decision formally takes the status of a law, and a conflict between entitlement legislation and budget constraints represents an incompatibility between laws that may occur in other areas as well. The standard solution is that the entitlement takes priority and that parliament *ex post* absolves the administration of the overrun, at least as long as there are other expenditures below budget to offset the overrun. Some countries have formalized rules of transfer within or between chapters that delineate the freedom of action of the administration. In Sweden, the budget does not have the status of a law, and there is no question about the authority relationship between this decision and entitlement legislation. Nonetheless, the constitution is very strict in maintaining parliamentary authority over public spending (Ch. 1, §4 of the constitution prescribes that "Parliament [...] decides on state taxes and the use of public money.")

There are basically two different approaches to the conflict in question, which are complements rather than substitutes. The first is to reduce the risk of acute conflicts, either by improving forecasting capacity or by reducing the inertia of the expenditure system, or both. Forecasting plays a central role both during the budgeting phase and as a component of the in-year follow-up activities. The political element in budget forecasts is in most cases detrimental to forecasting accuracy, and the production of forecasts should as far as possible be done in professional groups separately from the political deliberation process. This can be done either by delegating the responsibility of production to an agency outside the government chancery, or by creating a professional working group within the chancery with a clear mandate to supply the best figures possible.

The reaction time of the administration to signals about potential overruns can be reduced both by legislative means and by establishing routines of reporting early-warning signals to the cabinet. An expenditure system driven by a government ordinance based on a generally phrased law is more flexible than a system directly based on a law where all rules and amounts are fixed in a law text. The latter alternative calls for a full-fledged parliamentary treatment in case expenditures have been underestimated, which increases the risk that an overrun will in fact occur.

The second group of measures deal with situations when an overrun has actually occurred. In most countries, entitlements and other expenditures that are considered mandatory are handled via so-called *open-ended* appropriations, in which case parliament *ex ante* authorizes the government to overspend as long as there is a law supporting the expenditure system in question. Parliament then

confirms this authorization *ex post*. In the pre-reform Swedish system, not even this *ex-post* confirmation was considered necessary, but the overrun was simply registered by the agency in charge of the central government accounting system.

The absence of sanctions in case an overrun occurs eliminates any interest in limiting or even screening the actual expenditure level. In order to generate and maintain such an interest, it is necessary to force the spending ministry in question, together with its subordinate agencies, to compensate for the overspending. Fluctuations can be smoothed either over time or across appropriations or chapters. As pointed out above, the Swedish constitution is very strict in assigning to Parliament the role of deciding for what purpose public resources should be used, which makes it difficult to transfer money between appropriations. This makes it more natural to rely upon a system of loans and carry-over procedures to ensure that the government has the necessary freedom of action.

SWEDISH BUDGETARY REFORM 1992-96

Background

Though the details of the recent Swedish macroeconomic crisis are not relevant to the present discussion, some qualitative information is necessary as a background. The deep recession that hit the economy in the early 90's affected all important aspects of the economy - economic growth, real interest rate, unemployment, exchange rate, budget deficit. The crisis culminated in 1992-93; the Swedish krona collapsed in November 1992, and the central government borrowing requirement (which is a better measure of the financial balance than the budget deficit), reached the unprecedented level of some 16 per cent of the GDP. Several commercial banks experienced severe problems, and a few of them went bankrupt and were taken over by the state. Economic growth, which was negative during the height of the crisis, eventually returned to normal levels, but unemployment has remained high, close to the European average.

Opinions quite naturally diverge concerning the causes of the crisis. Whereas some authors have stressed long-term, structural factors (Lindbeck et al. 1994), others have concentrated on political decisions taken rather close to the crisis, such as financial deregulation and the tax reform, or general macroeconomic policy (e.g. Calmfors 1993). Most commentators emphasize the role of political decisions in the boom-and-bust cycle, but some question the primacy of such factors (Agell & Berg 1996). Others, such as Freeman et al. (1997), have stressed the costs associated with the very transition from one policy regime to another.

Whatever the relative role of these and other explanatory factors, one of the major consequences was that Sweden's public budgetary institutions became subject to

severe stress. By any reasonable standard, they did not withstand the ordeal. This in turn triggered a discussion that eventually led up to institutional reform.

Evaluation of the budget process

The EC study

The budget processes of the EC countries were evaluated by von Hagen in a study commissioned by the CEC as part of the preparations for the Maastricht treaty (von Hagen 1992). The basic question asked was whether the budget processes of the member countries were stringent enough to make the rather strict convergence program credible. The treaty also contains a paragraph with this institutional condition explicitly spelled out (Art. 3 of the Protocol on the Excessive Deficit Procedure reads: "[...] The Member States shall ensure that national procedures in the Budgetary area enable them to meet their obligations in this area deriving from this Treaty.")

von Hagen's study was based on a questionnaire submitted to the ministries of finance of the member countries. The questions (24 in all) were grouped into five categories, dealing with the strictness of the three phases of the budget process (preparatory, parliamentary, and implementation), transparency, and long-term constraints. The answers were rated according to a more or less common-sense based scale, according to which a high score would indicate a strict budgetary discipline, and vice versa. The ratings were used in a statistical test designed to verify whether general structural features in the budget process are important to the outcome (the "structural hypothesis"), and whether multi-annual restrictions matter (the "long-term hypothesis"). Whereas the structural hypothesis was corroborated, the long-term hypothesis was not. The structural index turned out to explain about one third of the variation of the government net lending during the 1980's.

A few words of comment on the questionnaire are necessary. The interpretation of the answers to the questionnaire are in some cases open to discussion. As for the *preparatory phase* in the government chancery, the questions aim at measuring the agenda-setting power of the minister of finance, which is non-controversial, but there is one question on the way negotiations are organized which is not. von Hagen's rating gives a high score to bilateral negotiations between the minister of finance and the spending ministers, and a low score to plenary discussions. Whereas arguments can be given for this rating, we find the arguments for a reverse rating stronger. One of the central components of the new process in Sweden is a two-day plenary cabinet discussion during which the basic budget parameters are set, and it is obvious that the plenary form is vital in this context, for reasons given above. During the discussions, the proposal of the minister of finance is discussed by the cabinet members, and any spending minister wishing to increase spending in her own field has to prove her case in front of the other

ministers. In this way, by making the overall macroeconomic budget constraints strongly felt in the cabinet circle, the group of spending ministers is thus forced into maintaining its own social control without the intervention of the minister of finance or the prime minister. On this point, we are at odds with the recommendations implicit in von Hagen (1992) and Alesina & Perotti (1996).

As for the *parliamentary phase*, the general idea behind the questionnaire is that the more the budget handling approaches a take-it-or-leave-it procedure, the stronger is the discipline. We find little reason to argue with this proposition. An often-heard argument against offsetting rules and other restrictions on M.P.'s' freedom to put forward proposals is that even where this freedom is great (as in the Swedish pre-reform process), the net addition to the total expenditure level stemming from parliamentary proposals is small, in particular in relative terms. This argument neglects the fact that the government anticipates the reaction from parliament when designing its budget proposal; the latent effect of liberal counter-proposal rules is most likely much greater than the visible one.

The rating assumes implicitly that parliament is more expenditure prone than the central administration. We find this a reasonable baseline assumption, although it has been questioned (Krehbiel 1990). The new decision procedure adopted by the Swedish parliament in 1994 is independent of this assumption, however, and tends to favour the least expenditure-prone part (government *or* parliament).

Concerning the *implementation phase*, the questionnaire places relatively large weight on formal blocking procedures controlled by the ministry of finance. Again, there are arguments in favour of such a rating, which reflects a continental public management tradition prominent in Germany and France, but arguments to the contrary can be produced. It is possible that greater flexibility for spending agencies when traded against stricter responsibility yields a better net outcome.

The *transparency* dimension is undoubtedly one of the most important ones for maintaining accountability not only in the relation between parliament and government but also in relation to mass media and the plebiscite. To the *completeness* aspects appearing in the questionnaire - accounting for extrabudgetary funds, loans, coupling to the national accounts - one should add the principle of *gross budgeting*. This principle, amounting to a complete separation between revenues and expenditures - that is, no netting applies on the expenditure side - is instrumental in providing an accurate picture of the actual expenditure level. During the early 90's, Swedish central government net expenditures for the unemployment insurance appeared on the revenue side with a minus sign - a most unorthodox representation, indeed. The corresponding labour market fund accumulated a deficit of 87 billion SEK (currently the equivalent of more than 11 billion USD) without formal consent from Parliament, which was, by any reasonable standards, a violation of the constitution. The fund was integrated into

the general central government debt in 1995-96 and management was taken over by the National Debt Office.

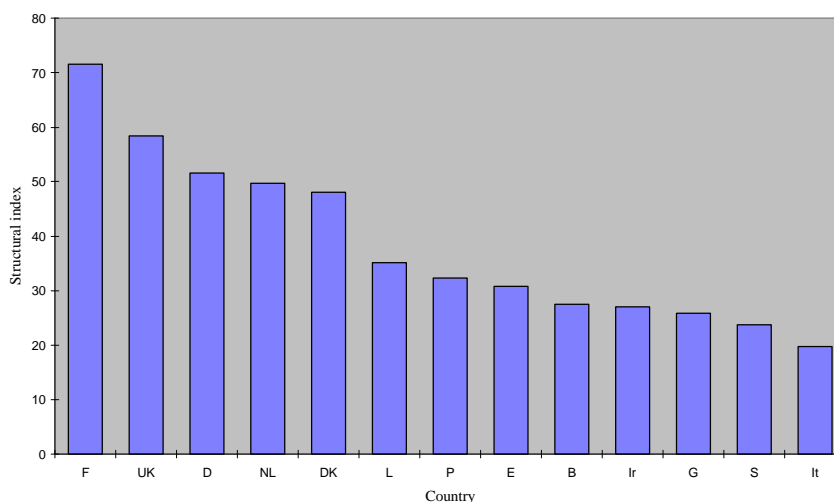
The *multi-annual dimension*, finally, is measured both by its content - targets, horizon - and the degree of political commitment. In our opinion, political commitment is the basic issue; good forecasts or a long planning horizon are of limited value unless supported by political clout. This may be the reason why the multi-annual dimension turned out to be non-significant in the linear regression; the dependence should be multiplicative in degree of commitment and horizon rather than linear. In the Swedish reform package, a multi-annual budget restriction plays a central and, we believe, justified role.

The structural index gave the highest score in 1992 to France (70 plus), the UK, and Germany, and the lowest to Greece and Italy (between 20 and 25). The regression equations estimated indicate that a difference in score of 1 unit corresponds to a steady-state difference in national debt of about 0.9 per cent of the GDP. The above discussion indicates that single questions and scores are open to discussion; nonetheless, the ranking quite obviously reflects some basic differences in budgeting practices between the EC member countries at the time, with visible effects on the fiscal policy of the respective countries.

Evaluation of the Swedish budget process, 1992

The Swedish budget process was evaluated by the author in 1992 using the same format as in the EC study, reflecting practices in 1991-92 (Molander 1992). The score turned out to be low, placing the Swedish process between Greece and Italy at the lower end of the ranking list (see Figure 1).

Figure 1. Structural indices for the budget processes of the twelve EC countries and Sweden in 1992.



Source: von Hagen (1992), Molander (1992)

The analysis and the succinct reform proposals were reiterated in the report from the Economic Commission (Lindbeck et al. 1993). The report provoked some discussion, *inter alia* in a commission of inquiry led by the chairman of the parliament, working at the time of the publication with various aspects of working routines in parliament. The commission published its reform proposals in 1993-94 (Talmanskonferensen 1993/94:TK 1-3), which were accepted with one minor exception (a proposal for an enlargement of the Parliamentary Audit Office, which was referred to further inquiry) in 1994. The most important changes were a transition to a two-stage budget decision procedure based on a top-down approach, a coordinating role for the Committee on Finance, and a transition to a calendar based budget year.

Another change that contributed to a strengthening of the budget process was a prolongation of the mandate period from three to four years. Further, in the spring of 1995, parliament voted for an expenditure ceiling, which gave further impetus to the budgetary reform.

The remaining parts of the package were developed by the government chancery during 1995, and the new procedure was adopted during 1996, to be in full effect as of January 1st, 1997.

Main elements of reform

General

The new Swedish budget process represents an orthodox *top-down approach*. Budget discussions start from a medium-term forecast of the economic development, and an associated projection of government revenues assuming the tax system as given. Expenditures are projected on a micro basis (appropriation-wise), on the basis of common macro-economic and other assumptions. The expenditure aggregate and the revenue forecast is confronted with budget-political restrictions, such as the Maastricht conditions and other, self-imposed restrictions (for instance, a public-sector balance requirement for 1998). In case any of the general restrictions are violated, countermeasures are sought among expenditure reduction proposals or tax increases, or a combination of the two.

The *annual budget cycle* is now calendar based (previously running from July 1st through June 30th). This may seem an administrative change of little or no significance, but it does permit a closer coupling between budget statistics and national accounts that helps maintain analytical discipline. A drawback is that budgeting becomes cumbersome in election years, because elections are held in September at the same time as the budget proposal is normally presented. An extraordinary procedure is envisaged in the new parliamentary order to allow a possibly new government to present its own budget proposals, but even with this modified time schedule, work conditions in the government chancery and in parliament become subject to severe stress.

The *mandate period* of parliament has been prolonged from three to four years, an undisputably beneficial change.

The basic rules governing the budget process and specifying the delegation of financial power from parliament to government have been collected in a *budget and fiscal management act*. This act collects, in some 50 paragraphs, the basics of the regulatory framework and serves as a transition between the stylized formulations of the constitution and a number of fine-grained government ordinances.

Preparatory phase

The general outline of the top-down procedure was given above. A central component of the process is a two-day conference in March, during which the basic parameters are set - the expenditure ceiling, the outline of next year's budget, and other central aspects, such as budget restrictions at the macro level. The outcome of these discussions is published in the economic spring bill in April, in order to stabilize the continuation of the budget process within the government chancery.

A change with far-ranging consequences is that *open-ended appropriations have been abolished*. In order to handle stochastic variations in rule-driven expenditure systems, so-called *flexible appropriations* are used. These admit of a limited borrowing possibility and conditional carry-over to the following budget year. Borrowing is normally limited to 3 per cent for administrative expenditures and 5 per cent for transfers. Parliament has consented to give the government the freedom of raising the credit to 10 per cent in exceptional cases. If use is made of the credit possibility, the agency enters the following year with the credit automatically deduced from the budget appropriation.

It is important to stress that this change *per se* does not affect the underlying expenditure dynamic. The objective is rather to modify modes of behaviour among the persons administering a given system. The fact that an agency is not permitted to hand out more than a prescribed sum of money (budget figure plus a credit specified in the instruction to the agency) necessitates a formal demand from the agency to the government in case an overrun is foreseen. This in return requires that the management has reliable forecasts on which to base such a demand, so *forecasting* becomes a high-priority activity in the agency. Because the spending ministry must have knowledge to match its agency, an interest in *follow-up* activities and forecasting is generated also in the government chancery. An actual decision to raise the credit is taken by cabinet collectively and therefore normally gives rise to a discussion on political priorities in the cabinet circle.

The carry-over possibility is not unconditional. Unused resources will be scrutinized in the annual budget dialogue. On the other hand, automatic elimination of any surplus will destroy incentives to sound and efficient management, so a careful trade-off has to be met with due regard to specific circumstances.

Parliamentary phase

Also the parliamentary phase of the budget process represents a textbook top-down approach. During its spring session, parliament votes on the proposal for expenditure ceiling, which locks the basic parameters of the budget, for instance total central government expenditure excluding interest on central government debt, for the following year. At this stage, the opposition has the possibility of proposing other figures for the expenditure ceiling. Given the normal party configuration in parliament, the chances of success are small even if government is supported only by a minority, because opposition parties to the left and right must form a winning coalition around an alternative proposal.

The full budget proposal, presented in September, must conform with this decision. It consists of a repartition of total expenditure into a number of *expenditure areas* (currently 27). These expenditure areas are further divided into activity areas and appropriations (about 500 in all).

The processing of the budget bill in parliament is coordinated by the Committee on Finance. The budget bill is referred to the various standing committees for comments. During the first stage of the process, it is possible for opposition parties to propose alternatives both on total expenditure and its composition. Parliament then votes on a repartition of total expenditure over the expenditure areas, the spring decision on total expenditure being a binding restriction (*binding* in the sense that parliament has to take a formal new decision if it is to deviate from the previous one). During the second stage of the parliamentary process, the standing committees analyze the details of the budget proposal. Any counter-proposal from opposition parties or M.P.'s at this stage must be at least offsetting, that is, a proposal for an increased or new expenditure must be matched by another proposal that reduces expenditure by *at least* the same amount. This procedure guarantees that the least expenditure prone policies of government or parliament will in fact prevail. This is in stark contrast to the previous system, in which it could very well happen that there was a majority for an increased expenditure *and* a majority for offsetting this change by decreasing some other expenditure, but where this offset never came about because there was no majority on which offsetting change to choose.

Implementation

As indicated above, the use of flexible appropriations for rule-driven expenditure systems calls for a developed *forecasting* and *follow-up* system. Developing routines and models for better forecasting practices is a long-term venture, and it should be recognized that forecasting the demand for, e.g., social insurance is a theoretically difficult problem. Increasing mathematical sophistication is no guarantee for higher reliability. The single-most important goal is to eliminate, as far as possible, the general political element in forecasting.

All appropriations are followed up on a monthly basis, and executive summaries with a focus on problematic appropriations are presented to the cabinet four times per year. Parliament is informed about the in-year budget situation twice per year, in connection with the economic spring bill and the budget bill, respectively.

Follow-up of results, which is an essential component of a management-by-objectives policy, has been strengthened. A major problem is that the capacity for receiving and processing results information is inadequate both in the government chancery and in parliament. Information on performance has traditionally been too technical and not very well adapted to the needs of the political level. Given the range and complexity of the matter, this - like the development of forecasting capacity - is a long-term venture.

Transparency

The principles of a *comprehensive budget* and *gross budgeting* were by and large established in the 1995-96 budget. Some old extra-budgetary funds remain but should eventually be integrated into the general accounting system.

Tax expenditures are now reported annually. The control of tax exemptions of various kinds becomes particularly important in the presence of an expenditure ceiling, given that a cap on the expenditure total increases the temptation to play with subsidies on the revenue side of the budget.

The system of guarantees is under revision. The aim is to carry out a separation between the commercial and the non-commercial components of the guarantee system. The ideal procedure is that new proposals for guarantees be referred to professional judgement of a bank or an agency with financial competence, and an appropriate fee assigned to the project based on the calculated risk. In case there is a political majority for going through with a commercially non-viable project, the subsidy necessary should be subject to standard scrutiny within the framework of the ordinary budget process, and eventually become visible on the expenditure side of the budget. A problem is that guarantees are often coupled to projects several years ahead, beyond the standard budget horizon, which makes them difficult to integrate into standard discussions on priorities.

Long-term components

A major new component in the budget system is the *expenditure ceiling*. It is *tri-annual, nominal* and comprises, as far as binding constraints are concerned, *central government*. Possible alternatives for the time horizon are three, four, or five years. Three years is the minimum for the restriction to be meaningful, and beyond five the uncertainty inherent in economic forecasts makes binding commitments nonsensical. For comparison, the UK expenditure ceiling is tri-annual, whereas the Dutch is tied to the parliamentary mandate period. The Swedish ceiling is translated annually, implying that the new decision each spring only concerns the third year of the period, unless there are strong reasons for a modification of the commitment already made.

The *nominal* character is easy to justify. Total expenditure is affected by literally hundreds of factors - some of which are behavioral, others purely financial - and there is simply no reason to treat the inflationary rate differently from other factors by making automatic adjustments.

The main blocks of the expenditure ceiling are budget expenditures, extrabudgetary social-security expenditures, and local government. Because of the autonomy of local government, including right of taxation, the ceiling for this sector is purely computational. Interest on central government debt is excluded from the ceiling for

the reason that this item cannot be influenced in the short run; restrictions on the ability to service debt is in fact likely to increase the cost of debt management and should be avoided.

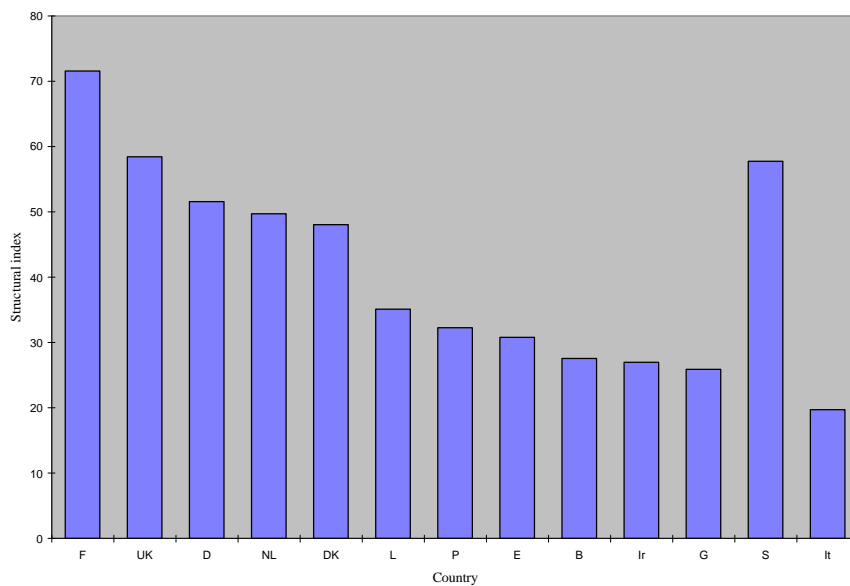
The expenditure ceiling contains a budget margin to account for forecasting uncertainty. This margin is fictitious in the sense that it is not included in apriori expenditure ratios, deficit calculations, etc. Its *raison d'être* is to reduce the risk of frequent modifications of the ceiling due to stochastic fluctuations in the expenditure aggregate. On the other hand, too large a margin makes the budget constraint too soft, so a trade-off has to be met. When the expenditure ceiling parameters were first set in 1996, the margin was set at 1.5, 2, and 2.5 per cent of total expenditure for the years 1997 through 1999.

Because the margin is not included in balance calculations, it cannot be used for new expenditures unless new revenues are raised; balance restrictions will otherwise be violated. New revenues may stem from unexpected increases in tax bases, or from increased tax rates.

Post-reform evaluation

The Swedish process was re-evaluated according to von Hagen's structural index in 1996 following the reform decisions. The score was increased by some 30 points, raising Sweden's ranking from the second-last position to the leading stratum, on a par with Germany (see Figure 2).

Figure 2. Post-reform structural index for Sweden (1996). Other countries have not been updated.



According to the regression equation for the debt-to-GDP ratio, this corresponds to a decrease of just below 30 per cent of the steady-state debt ratio (about 500 billion SEK, or 65 billion USD).

Other up-dates of previous evaluations have recently been presented (de Haan et al. 1997, Perotti et al. 1997, OECD 1998). The general impression is that budgetary institutions have been modified in several countries during the 90's, but less thoroughly than in Sweden. The general conclusion on a relative strengthening of the Swedish budget process thus seems firmly based.

Continued reform

The first experiences from post-reform budget practice has revealed a few remaining weaknesses. The first concerns the so-called *supplementary budgets*. As in other countries, the Swedish constitution opens the possibility of in-year amendments to the budget due to unforeseen events. Most of these surprises can be handled by the general flexibility inherent in the budgeting rules, but some are too large to for such a procedure to work. Further, completely new projects - even small ones - should not be handled this way but should be subject to political scrutiny in parliament.

The supplementary budget proposal gives room for counter-proposals and other political initiatives from opposition parties or single M.P.'s, and this procedure is at present not formally subject to the same stringent discipline as the main budget decision. There are indications that this opportunity may be exploited in the future. To bar this possibility, it is important that the same offsetting rules and the coordinating role for the Committee on Finance be applied in connection with supplementary budgets.

There have also been a few instances of "missions" from standing committees in parliament, whose members have realized that the road to raising expenditure levels goes via the government. To what extent government behaviour will be dictated by such missions depends on political considerations and is very difficult to forecast.

Another experience, in fact realized from the very outset, is that the *information system* supporting the budget process is inadequate for the more stringent requirements posed by the new process. A better integration between budgeting, forecasting, payments, and accounting and audit is necessary if the central administration is to live up to the higher level of ambition defined by the new process. Information system development is more likely to be successful when driven by strong demand. In this sense, conditions are relatively favourable given that the basic, politically more complicated institutional changes have already been made.

A final evaluation is not possible at this early stage. As noted by the OECD Senior Budget Officials (OECD 1998), "the true test of the new arrangements will come as the crisis atmosphere that has surrounded fiscal policy in Sweden goes away and it will become apparent whether the new system will be able to sustain the improvements achieved in the fiscal position."

THE POLITICAL ECONOMY OF REFORM

A common message from public-choice-theory inspired analyses of public institutions is that power relations are gridlocked in a political/institutional equilibrium, and that prospects for institutional reform are bleak. Against the background of the Swedish budgetary reform, it is natural to ask what made change possible.

Crisis

During the early nineties, Sweden experienced its deepest macroeconomic crisis since the nineteen-thirties. As illustrated above, all standard economic indicators testify of the serious disequilibrium. The onset of the crisis was rapid, and public finances were among the most severely affected. This created preparedness in the political establishment to consider institutional change that affected the distribution of power both within parliament and between parliament and government. The

deep crisis is consequently a necessary, but by no means sufficient, condition for change; other countries have had similar experiences without changing their institutions noticeably.

General climate of reform

The eighties saw a number of reforms in the area of economic, fiscal, and monetary policy. A tax reform in the mid-eighties aiming at lower marginal tax rates was followed in 1990 by a major reform based on broadened tax bases and lower tax rates.

Important changes took place in the area of monetary policy. In the early eighties, treasury bills and treasury bonds were introduced as new instruments of government borrowing. Liquidity ratios and interest-rate controls were removed, and the Bank of Sweden moved towards a more market oriented monetary policy. Foreign exchange regulations, dating from the Second World War, were completely dismantled in 1989.

Textile quotas within the Multi-Fiber Agreement were dismantled in 1988. All important domestic regulations in the agricultural sector were abolished in 1990, whereas border protection was made dependent on the outcome of the GATT negotiations. Both of these policy reforms had to be rolled back when Sweden joined the European Union in 1995.

Corporatization, and to some extent privatization, was applied to a number of state-owned activities in order to increase management efficiency. Telecommunications and electricity are major examples.

This general climate of deregulation and reform did not affect all areas, however. Labour market policy has remained intact. Social policy began to be affected only when the crisis was already under way, and even then not structurally but mainly in the form of reduced remuneration levels.

Government budgetary institutions were at first also largely unaffected. A modernization of the financial management system was announced in the budget bill of 1988, comprising business-like accounting practices and cash management methods, as well as an attempt to apply management-by-objectives methods in expenditure areas where this was considered appropriate (which covered but a minor fraction of central government expenditures) (Ministry of Finance 1993). These changes were well founded and have undoubtedly raised the general level of economic competence in government agencies. It is less clear to what extent public money is being used more efficiently today than before this reform. Unquestionably, these changes had little or no impact on the expenditure pressure or the deficit problems that hit the public sector in the early nineties. To handle such problems, other instruments are called for.

In summary, there was a general climate of reform in Sweden following the important deregulation in a number of markets and the tax reforms during the eighties. It should be stressed, though, that the general impact of these reforms was not as deep as in, for instance, New Zealand (Evans et al. 1996). A number of markets and legislative complexes were left intact. Still, a cluster of reforms may be sufficient to create an impetus for change in new areas.

Winners and losers

Although budgetary reform is a game with no obvious winners, the other and positive side of the coin is that there are no obvious losers that are easily mobilized to block the reform attempt. Institutional change is at arm's length from everyday political battles, and it was not altogether easy for an opponent of the basic ideas behind the reform to organize resistance.

In the administration, the most sceptical attitudes were taken by officials responsible for core functions of the welfare state - social security and labour market policy - in the ministries of social affairs and labour and their subordinate agencies. A general suspicion was expressed that an expenditure ceiling and associated instruments might constitute an obstacle to classical counter-cyclical public expenditure policies. This fear was voiced also in the parliamentary debate on the proposal by representatives from two parties represented in parliament - the Left Party (former communist party) and the Green Party. Symptomatically, these are parties for which the likelihood of joining a future government is small. Other opposition parties, which may well be represented in future governments, saw the general benefit and were also in a position to appreciate this benefit. (Following the 1998 elections, the Social Democrats, the Green Party and the Left Party have decided on cooperation in Parliament during the mandate period. By all likelihood, the latter two parties will not be admitted to the government, however.)

In the public debate, power distribution is commonly presented as a zero-sum game. The budget reform is no exception to this rule, and the general view among commentators was that government increased its power at the expense of parliament. As should be clear from the above account, this is true *in some respects* - for instance, it is more difficult for an M.P. or an opposition party to bring about changes in the budget proposal than in the previous system. Further, a paragraph in the budget law clearly states that budgetary resources assigned to a certain purpose need not be spent if the goals have already been fulfilled, or if other particular circumstances justify such a decision (e.g., the discovery of criminal behaviour in an organization receiving subsidies, or acute state financial difficulties), a paragraph which provoked debate in parliament.

On the other hand, parliament's power over government has increased in other respects, for instance via obligations laid down in the fiscal management act to report on potential overruns and to suggest countermeasures.

Agencies are more obvious losers in the power game; their freedom of action has been circumscribed. But the *status quo ante* was one of exceptional autonomy in international comparison, and to the extent that sloppy handling of public money is made more difficult by the new procedures, this is hardly a legitimate basis for criticism.

Reform package

The reform proposal was supported by empirical research from a number of countries, which, although having political and constitutional traditions different from Sweden's, were close enough to be considered relevant. Further, the message from this literature was easy to relate to common-sense notions on the workings of the budget process, and was possible to summarize in a fairly efficient format (such as von Hagen's structural index). Packaging may be as important in a political debate as it is in a market context. Economists arguing for lower taxes on the basis of welfare diagrams and tax wedges face a more difficult pedagogical problem.

Agents of reform

The individual element in the area of institutional reform is not to be neglected. In the case at hand, reform was facilitated by the presence of an important recipient of the main message, in the form of a commission in parliament working on related issues. Further, a successful reform initiative requires a group of senior officials willing to take a pro-active role in the process of change, with the risks and uncertain benefits that such an active attitude entails.

CONCLUSION

The positive message from recent development of budgetary institutions in Sweden is that substantial institutional changes are possible under favourable conditions. No major backlash is currently foreseen; the segments of the political establishment in favour of reasonably strict budgeting rules, including most party leaderships, have gained the upper hand in the debate. But the true test of the new procedures will come as the general sense of crisis fades and the next slump in the business cycle puts new strain on public finances.

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