



# IMF Working Paper

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## Expenditure Ceilings—A Survey

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Fiscal Affairs Department

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**Abstract**

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This paper looks at the factors that have to be considered when designing an aggregate expenditure ceiling. It is argued that expenditure ceilings are effective in promoting fiscal discipline and sustainability, but that a number of trade-offs have to be made when setting up a fiscal framework that will survive in a politically charged environment. The paper illustrates the discussion with a case study of medium-term aggregate expenditure ceilings in three countries: Finland, the Netherlands and Sweden.

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| Contents  | Page |
|---|------|
| I. Introduction .....   | 3    |
| II. Expenditure Ceilings—What are They, and Why do They Work?.....              | 4    |
| A. Why An Expenditure Ceiling?.....   | 4    |
| B. Comprehensiveness.....   | 6    |
| C. Inflation Adjustments.....   | 13   |
| D. Mechanism to Manage Expenditure Fluctuation .....                            | 15   |
| E. Time horizon .....   | 16   |
| F. Numerical Definition—Growth Rate, Percentage of GDP or Absolute Figure ..... | 17   |
| G. Legislative Status.....  | 19   |
| III. Finland .....  | 20   |
| A. Comprehensiveness.....   | 20   |
| B. Inflation Adjustment .....   | 26   |
| C. Mechanisms to Manage Expenditure Fluctuations .....                          | 26   |
| D. Time Horizon .....   | 27   |
| E. Numerical Definition.....  | 27   |
| F. Legislative Status.....  | 28   |
| IV. The Netherlands.....  | 28   |
| A. Comprehensiveness.....   | 29   |
| B. Inflation Adjustment .....   | 33   |
| C. Mechanisms to Manage Expenditure Fluctuations .....                          | 34   |
| D. Time Horizon .....   | 36   |
| E. Numerical Definition.....  | 36   |
| F. Legislative Status.....  | 38   |
| V. Sweden.....  | 38   |
| A. Comprehensiveness.....   | 38   |
| B. Inflation Adjustment .....   | 42   |
| C. Mechanisms to Manage Expenditure Fluctuations .....                          | 43   |
| D. Time Horizon .....   | 44   |
| E. Numerical Definition.....  | 45   |
| F. Legislative Status.....  | 46   |
| VI. Conclusion .....  | 47   |
| Summary Table.....  | 50   |
| References.....   | 51   |

## I. INTRODUCTION

Maintaining a sound fiscal position is a challenge for any government. The complexities of coordinating and prioritizing a large number of resource bids, difficulties in assessing and giving justice to the full economic effect of tax and expenditure policies, and inability to extend the time-horizon far enough to capture relevant future consequences, all threaten the stability of public finances. Repeated cases of rapid fiscal deterioration in countries across regions, of varying income levels, and of different ideological orientation indicate that the forces undermining fiscal sustainability are of a general nature, and deserve to be taken seriously. At the same time, comparable countries in similar economic conditions display drastically different fiscal performance. The prevailing political culture and the personal characteristics of elected representatives are, without doubt, crucial factors in explaining this difference. A complementary—and to a certain extent interlinked—reason for the variation has to do with the institutional arrangements for public decision making.

Numerous institutions have been recognized to affect the fiscal outcome, ranging from the election system and party structure<sup>2</sup> to the organization and regulation of the budget process.<sup>3</sup> Among the latter, fiscal rules—defined as formalized numerical restrictions on relevant aggregate fiscal parameters—can foster fiscal discipline by simplifying decision making, promoting an interest in sustainability issues, and reducing the scope for time-inconsistent decisions.<sup>4</sup> A wide range of fiscal rules is conceivable, and the choice and design of the appropriate fiscal framework partly depends on each country's specific circumstances. Generalizations about the effectiveness of a particular regime are inherently difficult to make,<sup>5</sup> particularly because the political setting tends to be unique. Nevertheless, the successful experience with *expenditure ceilings* in a few countries suggests that formalized restrictions on aggregate expenditure can be a valuable component of a framework intended to cultivate fiscal stability.

In this discussion, an expenditure ceiling refers to an *overall restriction on the outcome of all or most of government expenditure, established well in advance* of the start of preparation of the budget. That the ceiling is an overall restriction distinguishes it from the ministerial or sectoral expenditure limits that are set in the early stages of a top-down budget preparation process, and from the appropriations that together add up to the budget. An expenditure ceiling is an independent decision on the maximum level of expenditure—not the simple sum of a number of lower-level restrictions. Setting the ceiling in terms of the ex post budget

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<sup>2</sup> See for example, Grilli et al. (1991), Lijphart (1999), Roubini and Sachs (1989), and Persson and Svensson (1989).

<sup>3</sup> See for example, Ferejohn and Krehibel (1987), von Hagen (1992), and Hallerberg and von Hagen (1997).

<sup>4</sup> See Kopits and Symansky (1998) for an overview.

<sup>5</sup> See Schick (2003) for a discussion on the role of the political environment in successfully implementing fiscal rules. European Commission (2006) makes an empirical evaluation of the effectiveness of fiscal rules.

outcome—rather than ex ante budgeted amounts—separates it from a budget preparation phase of deciding overall expenditure. That the expenditure ceiling covers all or most of government expenditure implies that it may not necessarily correspond to the budget structure. The expenditure ceiling is intended as an instrument for enforcing aggregate expenditure discipline irrespective of how government finances are organized. Setting the expenditure ceiling before the budget negotiations are initiated implies that the ceiling guides the preparation and execution of the budget, not the other way around. In practice, expenditure ceilings become the anchor for a medium-term framework.

Expenditure ceilings are not homogeneous. First, in deciding which expenditure categories to include under the ceiling, a balance has to be struck between the ambition to enforce strict discipline over spending, on the one hand, and the need to allow for a certain justified variation of expenditure, on the other hand. Countries have come to different conclusions regarding how comprehensive the ceiling should be, which partly reflects a difference in their political, economic, and fiscal conditions. A second factor that has to be considered is how a binding ceiling on expenditure can be reconciled with variations in inflation. Although an inflation correction to ensure that the ceiling in real terms remains constant makes intuitive sense, there are practical obstacles that complicate such adjustments. Again, no clear picture emerges from studying country practice. Third, while there are indeed strong arguments for setting aggregate expenditure restrictions in a medium-term perspective, there are several options for formulating such multi-annual ceilings. Fourth, the principles for determining the level of the expenditure ceiling and the explicitness of the link with other fiscal objectives can vary. Fifth, there are numerous possible options for managing unexpected events. The weight attached to the advantages and disadvantages of the various flexibility mechanisms has to be evaluated in the context of the individual country. Sixth and finally, there are many possibilities for the status of the expenditure ceiling along a continuum from a unilateral government commitment to regulation in standing legislation. These six characteristics are discussed in this paper, and illustrated by a comparative study of the expenditure ceiling regime in three countries: Finland, the Netherlands, and Sweden.

## **II. EXPENDITURE CEILINGS—WHAT ARE THEY, AND WHY DO THEY WORK?**

Through an expenditure ceiling, the government makes an early announcement of the maximum level of expenditure, and makes an explicit commitment not to exceed this level. Such a simple assurance can have a profound effect on the development of public finances by neutralizing many of the forces undermining fiscal sustainability.

### **A. Why An Expenditure Ceiling?**

An extensively explored aspect of public decision making is the difficulty of ensuring collective rationality. In the area of public finances, this translates into an intrinsic tendency

to expand the size of the government sector without a corresponding increase in revenue. Gravitation toward fiscally unsustainable policies appears to be a widespread phenomenon, rather than the odd exception. Unless this bias toward frivolous fiscal behaviour is somehow defused, fiscal difficulties could become a permanent problem.

The role that fiscal rules have played in bringing stability and predictability into previously chaotic situations has received increasing attention in the past decade, and there has been an active debate about what type of rule is most effective. At the outset, a distinction has to be drawn between the issue of assessing, on the one hand, which fiscal scenarios are consistent with sustainability in terms of revenue and expenditure levels and debt trajectories, and, on the other hand, the issue of which types of restrictions are effective in changing the behaviour of democratic institutions. Having a clear and realistic sense of the desirable development of aggregate fiscal parameters is a necessary, but in no way a sufficient, condition for actually generating such an outcome. It is essential that the rule addresses the source of the bias toward unsustainable policies, and expenditure ceilings appear to have an advantage over rules formulated for the balance or the debt in this regard. There are several reasons for this.

First, on an annual basis, or even over a few years, the government and parliament typically do not have full command over the fiscal outcome. Even under stable tax rules, revenue will fluctuate depending on the level of economic activity. Compensating for such changes by adjusting tax bases or tax rates is not a viable option in the short run. On a practical level, it is rarely possible to make swift changes in the tax legislation to respond to revenue variations. Even if this were possible, there are strong arguments for allowing revenue to fluctuate to enable an automatic stabilization that can smooth business cycle variations. Actively managing revenue to maintain a constant balance is likely to produce procyclical fiscal policies.<sup>6</sup> A third argument against such an approach rests on the theory of *tax smoothing*,<sup>7</sup> which states that the distortionary effects of taxation is minimized by maintaining a constant tax policy. The same case can be made for targeting public debt, where short-term variations, not indicative of the sustainability of current fiscal policy, are likely to occur. From an annual perspective, it is neither feasible nor desirable to impose hard restrictions on balance and debt. The argument for using an expenditure to guide fiscal policy comes, above all, from the fact that it is *operational* in a way that alternative rules are not.

Second, the principal origin of the lack of fiscal rectitude seems to be a tendency to excessively accommodate demands for expenditure increases, rather than overresponsiveness to appeals for tax cuts. A binding commitment on total expenditure can therefore provide valuable support in the formulation of fiscal policy. That the expenditure ceiling is

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<sup>6</sup> To some extent, the variations in the balance can be eliminated by focusing on the cyclically adjusted balance. Such adjustments introduce another difficulty, as it relies on an assessment of the non-observable potential GDP level.

<sup>7</sup> See Barro (1979) for a discussion of the tax smoothing hypothesis.

formulated in terms of the ex post outcome, rather than the ex ante budgeted figures, is crucial in this context. Supporters of particular policy proposals have incentives to underestimate the expenditure of policies in order to evade resource restriction in budget negotiations. Such a bias is reinforced by the difficulty of correctly assessing second order effects of government policies. The tendency to underestimate the fiscal impact of government undertakings—a fiscal illusion—can both be the intentional outcome of perverse incentives, and the result of imperfect information and the limitations of decision-making rationality.

A third and related argument for using an expenditure ceiling comes from a possible upper boundary in maintaining balance for all levels of expenditure. Where the tax wedge is already high, a further attempt to increase revenue to compensate for more expansionary expenditure policies may be thwarted by labour supply distortions that outweigh the tax increase. With mobile tax bases, this effect can occur even at relatively modest tax rates and a low elasticity of labour supply. Attempts to increase revenue by raising taxes could lead to an exodus of economic activity and reduced total revenue. In situations like these, controlling aggregate expenditure becomes the overreaching objective in order to preserve fiscal sustainability, which speaks in favour of using an expenditure ceiling.

Realistically, fiscal rules can only provide support in achieving an outcome that is recognized as being advantageous, but that is difficult to accomplish in the environment of public decision making.<sup>8</sup> A precondition for the successful introduction of a fiscal rule appears to be a certain understanding of the need for, and commitment to, sustainable public finances in political institutions. Rules that are perceived as too restrictive in relation to the government's policy agenda, or that give rise to effects that are politically unacceptable, have little chance of surviving. Striking the right balance between what is desirable and what is practical is one of the fundamental challenges in designing an effective fiscal rule.

## **B. Comprehensiveness**

A defining characteristic of an expenditure ceiling is its *comprehensiveness*. The effectiveness of promoting a sustainable aggregate expenditure development clearly depends on which items are restricted by the ceiling. Fiscal discipline speaks in favour of complete comprehensiveness.<sup>9</sup> This perspective has to be weighed against other aspects of fiscal policy, such as economic stabilization and the necessity of ensuring smooth government administration financing. Thus, there may be a justification for excluding certain items from the ceiling restriction.

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<sup>8</sup> Molander (2001) discusses the relationship between fiscal rules and democratic ideals.

<sup>9</sup> This is supported by a study of fiscal rules in the European Union, performed by the European Commission in 2006. "In the case of expenditure rules, it appears that an increase in the coverage of government finance by expenditure rules leads to a reduction in the primary expenditure-to-GDP-ratio." (European Commission, 2006).



An explicit principle of completeness, from which clearly motivated and unambiguously defined exceptions are made, is a good starting point. The effectiveness of the ceiling is to a certain extent dependent on its simplicity and transparency. Monitoring of compliance with the ceiling quickly becomes complex as the number of exceptions increases, and the benefit of not subjecting an expenditure category to the ceiling should be measured against this loss of clarity. A principle of full comprehensiveness may also facilitate preservation of the ceiling over time. Painful prioritizations and policy modifications are direct consequences of an effective ceiling, and arguments from sector representatives for exempting various expenditure categories should be expected. Requiring explicit justification for exclusion rather than inclusion can assist in defending the ceiling against gradual erosion.

The fundamental problem of comprehensiveness is one of *forecasting*. In a situation where all public expenditure could be perfectly forecasted in the time horizon for which the ceiling is set, the level of the ceiling could be calibrated to any temporary fluctuations around a structural expenditure level. Difficulty in producing accurate medium-term forecasts is an obstacle to employing an expenditure ceiling, but not in itself a reason for excluding certain expenditure categories. In the name of simplicity and transparency, there could also be a case for including expenditure categories that are stable and predictable, despite material arguments for exclusion.

A reasonable position is that the ceiling should include all expenditure categories that are subjected to the expansionary pressure in public decision making. Instances where the government simply acts as an intermediary, and expenditure fully corresponds to non-distortionary revenue, would seem to qualify for exclusion from the ceiling. This would, for example, be the case with public spending financed by donations or foreign grants. In practice, these criteria are rarely fulfilled. Although *self-financing* arrangements for certain expenditure are often set up, this type of earmarking does not eliminate the risk of underestimating expenditure and overestimating revenues. In the majority of cases, the government has an explicit or implicit subsidiary financial obligation for all public expenditure, regardless of how it is organized. In addition, the revenue source is rarely non-distortionary, and contributes to the tax wedge in the economy.

The fact that an expenditure category is difficult, or sometimes even impossible, to affect in the short run clearly presents an obstacle for a binding expenditure ceiling, but is not a sufficient reason for exclusion. Various types of entitlements, such as unemployment benefits, disability benefits and pensions, together with interest payments, are sometimes referred to as *mandatory*, or *non-discretionary*, *expenditure*, but such a classification is misleading. The degree of discretion that the government has over expenditure depends on the time horizon. In an annual perspective, a significant part of government expenditure—not only interest payments and entitlements—is fixed, not realistically negotiable, and could consequently be considered mandatory. However, over a period of, say, ten to fifteen years, virtually all expenditure items can be changed, rendering the classification of mandatory and

non-mandatory insignificant. The objective of the expenditure ceiling is to enforce a sustainable level of expenditure, regardless of the policy composition.

A more relevant distinction is to what extent it is *justified* to allow temporary variations in expenditure, without requiring compensatory reductions to maintain a constant aggregate level. Countercyclical fiscal policy is an obvious case. Random variations, which over time cancel each other out, are another. In practice, it is generally difficult to separate temporary effects from structural changes.

### **Interest Payments**

Interest payment on the government debt is one of the few expenditure categories for which the arguments for exclusion from the ceiling are compelling. None of the three countries examined below currently include interest payments under their ceilings, although the Netherlands did so until 2007.

To a large extent, interest expenditure is the result of historical decisions on revenue and expenditure. With a long outlook, it could be argued that the inclusion of interest payments under the expenditure ceiling could create incentives to reduce government debt. However, provided that the time horizon in budgeting is typically short, it is debatable to what extent the implications on future interest payments will be taken into account when formulating fiscal policy. This is not by itself an argument for excluding interest payments from the expenditure ceiling; it is rather a recognition that the effects of including interest payments are not likely to be particularly significant.

The major argument for excluding interest payments is, instead, that in the time horizon relevant to the expenditure ceiling, the potential variations are substantial, while at the same time being weakly related to the sustainability of current fiscal policy. Depending on the structure of government debt, short-term fluctuations in interest rates and exchange rates will have a direct impact on the size of interest payments. If interest payments were included under the ceiling, such events could require expenditure reductions or create room for expenditure increases in other areas of the budget, without this being justified from the point of view of sustainability.

Optimal debt management may call for changes in the composition of the debt and modifications in the debt instruments used. This could lead to variations in interest payments that are of a purely technical nature, but nonetheless affect the room for expenditure under the ceiling.<sup>10</sup>

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<sup>10</sup> For this reason, a number of countries are accounting for interest payments on public debt on an *accruals* basis. (See Blöndal, 2004.)

The inclusion of interest payments under the ceiling could possibly create incentives for the government to sell off assets to reduce the burden of debt service payments. Such decisions should be founded on a substantial analysis of requirements of the administration and of the role of the public sector, however. The fiscal framework should not introduce a bias for a lower asset position.

### **Non-cyclical Entitlement**

Part of the government's annual expenditure obligation comes about as a result of legislated benefits, such as health-related benefits, government pensions, and various types of financial support and allowances. In the short run, expenditure for these items is outside the government's immediate control. Criteria for the entitlements cannot be changed without a parliamentary decision, and total expenditure is determined by the number of individuals that are eligible in a given year. Simply placing an annual limit on expenditure for entitlements is not a viable option. The government has to meet its obligation under existing legislation, even if projections that were made when the budget was prepared are exceeded. The practical difficulties that can stem from an inclusion of entitlements under the ceiling should be recognized and analyzed, but they are not in themselves a sufficient reason for separating this type of expenditure from the ceiling. All of the three countries studied below include non-cyclical entitlements under their ceilings.

Recognizing the discretionary nature of entitlement systems in the medium term gives rise to an argument for subjecting expenditure on these items to an expenditure limit. First, by including entitlements under a medium-term ceiling, a discussion on the sustainability of total government policies beyond the upcoming year becomes a natural element of budget negotiations. A comprehensive expenditure ceiling requires an analysis of medium-term projections of all expenditure items, and provides incentives for the government to react early to weakening public finances, and if necessary to propose changes in legislation. Second, as the entitlement systems are part of the government's total policies, it is reasonable that they should be evaluated and compared to all other policies in the budget process. Excluding these systems from the ceiling reinforces the impression that entitlements are somehow protected from policy prioritization.

The decision to include or exclude entitlements from an expenditure ceiling does not depend on whether entitlements are organized in autonomous or semi-autonomous funds separate from the budget. Expenditure ceilings are intended to prevent an unwanted increase of expenditure, tax ratio, and deficit, regardless of the manner in which various policies are financed.

As pointed out by Carcillo and Grubb (2006), there may be interdependence among various transfer systems, and changes in the unemployment level may lead to increases in the

volumes in other transfer systems. By including all entitlement systems under the ceiling, possible incentives to disguise transfer expenditure by pushing individuals from one system to another are reduced.

### **Cyclically Sensitive Items**

An aspiration to smooth business cycle fluctuations through fiscal policies presents a challenge for a completely comprehensive expenditure ceiling. Both the inclusion and the exclusion of this type of expenditure have distinct advantages and disadvantages, and no clear message emerges from the three case studies. In the Netherlands and Sweden, all entitlements, including unemployment benefits, are placed under the ceiling. In the case of Finland, the majority of cyclically sensitive items are outside the ceiling.

From a macroeconomic point of view, a certain variation of public expenditure from year to year may be justified in order to diminish cyclical swings in production and employment. Although the possibilities of successfully running countercyclical fiscal policies have been fiercely debated in the academic literature<sup>11</sup>, there seems to be wide support for allowing the automatic stabilizers to operate without restriction.<sup>12</sup> These stabilizers predominantly work on the revenue side of the budget<sup>13</sup>, but cyclical variations in expenditures such as unemployment benefits should be expected. In addition to such automatic variations, governments may also want to undertake discretionary measures, such as labour market programs or employment subsidies, to further accelerate the return to equilibrium GDP levels in a particularly deep recession. The effectiveness of discretionary measures is debatable, however.<sup>14</sup>

When determining whether or not to include cyclically sensitive expenditure under the ceiling, the economic objective of allowing for countercyclical expenditure policies should be balanced against the aim of ensuring long-term sustainability in public finances. If a bias toward expanding the government sector is a prominent characteristic of public decision

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<sup>11</sup> Some of the reservations against the general effectiveness of countercyclical policies are the existence of a real business cycle and Ricardian equivalence.

<sup>12</sup> See Perotti (2005) or Andersen (2005) and Hemming et al. (2002) for a review of the literature.

<sup>13</sup> OECD estimates that, on average for its member countries, approximately  $\frac{3}{4}$  of the automatic stabilization is on the revenue side and  $\frac{1}{4}$  on the expenditure side. There is a noticeable variation of this ratio between countries, with for example new EU-membership countries exhibiting a significantly higher proportion of automatic stabilization on the revenue side, on average  $\frac{7}{8}$ . Girouard and André (2005).

<sup>14</sup> The distinction between automatic stabilizers and discretionary measures is not always clear. In a country with ambitious commitments to maintaining high employment levels, programs intended to improve the qualifications of unemployed individuals through education or subsidized placement in firms could be considered to be semi-automatic. By including such measures, the sensitivity of expenditure to cyclical variations rises. See Boije (2004) and Murchison and Robbins (2003) for a discussion on which factors should be considered cyclical.

making, this may well lead to successively expanding labour market policies, threatening the stability of the budget. The organization of unemployment benefits into an extrabudgetary labour market fund, with the right to collect certain contributions, does not mitigate this problem. As employment benefits typically are regulated through legislation, the government bears a subsidiary financial responsibility for any labour market policy obligation, irrespective of whether it is financed directly on the expenditure side of the budget or through earmarked revenue via an extrabudgetary fund.

A cyclical variation of expenditure around a structural level creates a series of practical problems in a regime with an expenditure ceiling. During an economic downturn, the increase in cyclical expenditure could be limited by the ceiling, or could crowd out other types of expenditure. If the economy performs above its potential, the expenditure decrease could open up new room under the ceiling, with a risk of procyclical policies and future difficulties in honoring excessive structural expenditure. The seriousness of these problems in a given country naturally depends on the sensitivity of government expenditure to cyclical variations, and the country's economic stability.<sup>15</sup>

Uncertainties in forecasts concerning the output gap and the elasticity of expenditure to cyclical variations make it difficult to *ex ante* establish a cyclically adjusted expenditure level.<sup>16</sup> Setting ceilings that take into account the projected cyclical position of the economy is, therefore, hardly a feasible option, particularly if ceilings are set in a medium-term perspective, when the uncertainties of cyclical expenditure are substantial.<sup>17</sup> A second possibility is to set a ceiling that would allow for a cyclical downturn, i.e. higher cyclical expenditure, and require an *ex post* margin between expenditure outcome and the ceiling when the economy is performing better. However, it may be difficult to defend such a margin from being used for new initiatives during an upswing. A third option would be to separate cyclical expenditure from structural, and only exclude the former from the ceiling. As with a cyclically adjusted ceiling, this approach relies on the ability to correctly assess the composition of government expenditure and divide it into permanent, cyclically adjusted and temporary components. Furthermore, such a construction would reduce transparency, create difficulties for outside monitoring, and open up possibilities for manipulating the classification of expenditure to circumvent the ceiling.

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<sup>15</sup> The effectiveness of countercyclical monetary policy is one important factor. For members of a currency union, such as the Euro area, the possibilities for national countercyclical monetary policies through changes in interest rates disappear. At the same time, an economic integration has the potential of stabilizing economic development and reducing cyclical variations.

<sup>16</sup> See, for example, Blanchard (1990) for a discussion on the cyclical adjustments of fiscal parameters.

<sup>17</sup> Switzerland uses a formula to calculate the expenditure ceiling that takes into account the cyclical position of the economy. This ceiling is set in a one-year perspective, however.

### Non-distortionary Earmarked Revenue

In some cases, there is a direct correspondence between expenditure and a well-defined non-distortionary source of revenue. Changes in the activity level result in an automatic and equal adjustment of both expenditure and revenue, with no impact on either the tax-wedge in the economy, or the fiscal balance. Although this clearly is a case of *earmarked revenue*, which is a violation of the fundamental budget principles of unity and universality, such arrangements exist in virtually all national budget systems. The treatment of these types of operations varies in the three countries studied here. In Finland, there is an explicit principle of not including expenditure that is *circular* in the sense that the government only acts as an intermediary. In the Netherlands, the ceiling is defined as being in *net* terms, indicating that certain expenditure is offset by revenue. In Sweden, the fundamental principle is one of gross treatment of revenue and expenditure in the budget and the accounts. Exceptions are made, however.

In many countries, some public expenditure is financed by sources other than domestic revenue or borrowing. Members of the European Union receive payments from the EU budget for agricultural subsidies, regional development, research, and social programs. An increase in a program fully financed through the EU budget results in a corresponding expenditure and revenue effect.<sup>18</sup> Analogously, developing countries often receive bilateral and multilateral financial support for particular projects. Common to these examples is that the programs and activities—and consequently the level of expenditure—is determined to a large degree by someone outside the government and parliament. Although there are strong arguments for coordinating all policies, regardless of how they are initiated and financed, programs over which national institutions have little influence are not likely to be subject to the expenditure bias addressed through the expenditure ceiling.

A related case is created when the government supplies goods and services for a user fee. Provided that the level of activity is determined by demand—rather than through a discretionary policy decision—and that there is full cost recovery through the fees charged, it may not be necessary to restrict expenditure. In most cases, however, it is difficult to ensure that these two conditions are fulfilled, and user fees are often used as a partial source of funding for goods and services that are of a clear public nature. For this reason, a gross budget treatment of revenue and expenditure for user fees—which subjects the level of activity to the expenditure ceiling—will be appropriate unless very specific criteria are met.

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<sup>18</sup> In the case that national co-financing is required from the member country, an increase in an EU program has an effect on the budget balance. In addition, to the extent that the national administration of EU programs is financed through the budget, there may be a net fiscal effect from an expansion of EU payments.

## **Investment Expenditure**

A medium-term restriction on aggregate expenditure can conceivably distort public investments—particularly infrastructure investment. There appear to be compelling arguments for some kind of special arrangement to ensure that long-term rationality in investment policies is preserved during the reprioritizations caused by a binding expenditure ceiling. In all of the three countries studied below, investment expenditure is to some extent treated in a separate fashion from other expenditure categories. In no country has investment been completely excluded from the ceiling, however.

As discussed above, the discretion over expenditure in the short run is typically limited. If total expenditure increases more rapidly than what was projected when the expenditure ceiling was established, it may be tempting for the government to make reductions in investments, as there may be scope for changing investment plans on short notice, and such measures could have a substantial impact.

A second issue arises because of the indivisibility of investment expenditure and the difficulty of accurately projecting the timing of individual payments. In a cash budget and accounting environment, delays in large infrastructure projects can have a substantial effect on aggregate expenditure, which could create room under the ceiling in one year, and put pressure on the ceiling another year.

Although these two issues give reasons for concern, they are neither unique to investment expenditure, nor sufficient to warrant exclusion from the ceiling. A third possible argument against including investment expenditure under the ceiling is that it generates economic returns over a long period, and cannot be directly compared to government consumption and transfers. In the time horizon relevant for policy prioritizations within an expenditure ceiling, there is therefore a risk that the benefits of investments would not be correctly identified. Such criteria for classifying expenditure are inherently difficult to establish, however, as numerous policies—such as education, health care and defense—have long-term economic welfare effects.

## **C. Inflation Adjustments**

The issue of how to take the impact of inflation on government expenditure into account is in many regards analogous to the issue of comprehensiveness. In essence, the potential distortions caused by inflation come about as a result of forecasting errors. The appropriate mechanisms for making inflationary adjustments to ensure that real expenditure is maintained at the intended level depend on the nature, level, and volatility of inflation. The practical problems of translating real parameters into nominal figures, and the loss of transparency this gives rise to, should also be taken into account. In Finland and the Netherlands, four-year ceilings are determined in real terms, and converted into nominal

terms shortly before the preparation of the annual budget begins. In Sweden, the three-year ceilings are set in nominal terms.

Virtually all public expenditure is affected by changes in the price and wage level, and the issue of inflation is not restricted to a particular expenditure category. Sensitivity to inflation is not uniform, however. For price- and wage-indexed transfers, nominal interest on inflation indexed government bonds, and any inflation-indexed grants, the inflationary effect is automatic and predictable. For a number of other items, such as the wage bill of civil servants, and grants and subsidies set in nominal terms by the government, the inflation adjustment leaves some room for discretion. For the goods and services purchased by the government, the inflationary effect is exogenously determined.

Provided that the inflation rate is constant—or more precisely, is accurately forecasted—the government can take into account future price and wage increases when setting the expenditure ceiling and preparing the budget. In a situation where there is an unexpected departure from forecasted inflation, a nominal expenditure ceiling could have unwanted effects on fiscal policy.

Ideally, the room under the expenditure ceiling should not be affected by events that have an equal impact on revenue and expenditure, and thus leave the general government balance unchanged. If this criterion is fulfilled for inflation, there would seem to be compelling arguments for setting the medium-term expenditure ceiling in *real terms*. In such a framework, the room for expenditure under the ceiling is neither squeezed nor expanded by errors in medium-term inflation forecasting.

An advantage of an expenditure ceiling is that expenditure development for various policy options can be measured against a firm point of reference—including any deferred effects in the medium term. In the case of a real ceiling, there is a certain element of ambiguity regarding the nominal, *i.e.*, operational, medium-term expenditure limits, which may reduce the clarity of the actual ceiling for a given year. In addition, the translation from a real to a nominal ceiling may create opportunities to revise the deflator to create additional room under the ceiling. Apart from reducing fiscal discipline, frequent changes in the method for translating the ceiling from real to nominal terms reduce transparency.

A different type of problem with the translation of a real ceiling into nominal terms is created by the non-uniform inflationary effect of government expenditure. The use of any of the standard deflators, such as the consumer price index or the GDP deflator, will not generate a true conversion, in the sense that the real room under the nominal ceiling will be larger or smaller than the real ceiling. This problem could be solved by using a deflator based on government expenditure. However, using such a non-standard parameter will further reduce transparency, and possibly the status of the ceiling.



A medium-term nominal ceiling may under certain circumstances introduce a counter-cyclical effect *on the expenditure side of the budget*. A temporary departure from full employment, caused by a shock to aggregate demand, would affect inflation and, consequently, nominal expenditure.<sup>19</sup> Such contraction of aggregate demand would reduce inflation, and would create room for additional expenditure under a nominal ceiling, which would allow room for the automatic stabilizers on the expenditure side of the budget.<sup>20</sup>

#### **D. Mechanism to Manage Expenditure Fluctuation**

The fundamental objective of an expenditure ceiling is to maintain expenditure at a sustainable level. More specifically, it is the structural, rather than the actual, expenditure level that should be restricted. As discussed above, a certain variation of expenditure from year to year may be justified, in which case it should be possible within the framework of the ceiling. To what extent such flexibility is needed depends on how the ceiling is constructed, and the type and magnitude of the variations. In Finland, where the expenditure is narrowly defined, and where the ceiling is set in real terms, variation in ceiling-restricted expenditure should be limited. Nonetheless, in the most recent revisions to the ceiling regime in 2007, some additional flexibility arrangements were introduced, indicating that the issue of how to manage variations in expenditure is still perceived as important. In the case of the Netherlands and Sweden, the wide comprehensiveness of the ceilings suggests that the risk of aggregate forecasting errors can be substantial. Unfavorable expenditure development has mainly been managed through reallocations and reprioritizations under existing ceilings, although there is evidence that insufficient room under the ceiling has also given rise to some dubious practices as substituting expenditure for tax expenditure, introduction of net budgeting and accounting, and deferral of payments from one fiscal year to the next.

Temporary variations around an underlying expenditure level are caused by a number of factors. Interest variations, cyclical factors, fluctuations in the number of individuals that qualify for legislated benefits, and inflation are discussed above. If unspent appropriations can be carried over to the next fiscal year, actual expenditure is to some extent at the discretion of line ministries and budget authorities. In addition to these factors, government expenditure is affected by other events which may be difficult to predict in advance. Investment projects may suffer delays, natural disasters may require government intervention, and contingent liabilities may fall due.

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<sup>19</sup> The impact of a lower than forecasted inflation would depend on the wage stickiness for civil servants and the time lag of price and wage indexation of transfer payments.

<sup>20</sup> It may be the case that the adjustment of the price and wage level is asymmetric in cyclical upswings and cyclical downturns, and that there is relatively stronger inflationary pressure when the economy is operating above potential output than there is downward adjustment when it is below. If this is the case, a nominal expenditure ceiling could function countercyclically in an economic upturn caused by a growth in demand, but be neutral in a downturn.

The amount and type of flexibility needed depends on the construction of the ceiling. A comprehensive ceiling will generally demand some mechanisms for dealing with an unfavourable development. Nominal ceilings require more flexibility than real ceilings in order to absorb unforeseen increases in inflation. The uncertainty in forecasts increases with the time horizon, and the further in advance the expenditure ceiling is established, the larger the expected variations in expenditure that must be accommodated.

Arrangements to allow temporary fluctuations of expenditure should not be made too generous, as this may erode fiscal discipline. In many cases, it is difficult to correctly identify whether a change in expenditure is temporary or permanent, and consequently whether discretionary changes in expenditure policy are warranted. In the interest of preserving fiscal discipline, it may in some instances, and to a certain extent, be justified to allow variations to be absorbed within the ceiling, i.e., by policy adjustment. Such an approach clearly has some disadvantages, as it may lead to some arbitrariness in the allocation of resources. The need for flexibility is obviously diminished by accurate expenditure forecasts for all years covered by ceilings, but will not eliminate revisions of projected expenditure, neither in the medium nor in the short term.

Given the uncertainty in medium-term expenditure development, planned expenditure generally has to be set at a lower level than the expenditure ceiling to ensure that the outcome complies with the ceiling. This difference between the aggregate expenditure restriction and the projected aggregate expenditure level—the *contingency margin*—can absorb unforeseen increases in expenditure. The size of the margin determines what types of forecasting errors the government can handle without having to cut expenditure. Provided that the uncertainty in forecasts is higher in the more distant future, the contingency margin could be reduced with time. A diminishing margin could be constructed either by allowing some proportion of the remaining margin to be used for new, expenditure-increasing reforms—in which case this part of the contingency margin is transformed into a *planning margin*—or by successive reductions of the expenditure ceiling in the absence of upward revisions of the expenditure forecast.<sup>21</sup>

## E. Time horizon

Under an expenditure ceiling, revenue and expenditure are separated, and once the ceiling has been determined, revised revenue forecasts do not affect the room for expenditure. In this context, it becomes important to decide in what manner, and how far in advance, the expenditure ceiling should be set. Country experience points toward two distinct approaches:

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<sup>21</sup> See Lindh and Ljungman (2007) for a discussion of various approaches for managing expenditure fluctuations within an expenditure ceilings regime.

a fixed-term versus a rolling ceiling. Finland and the Netherlands use the former model, and set four-year ceilings corresponding to the term of the government. Sweden annually establishes a ceiling for the third additional fiscal year. With the two ceilings determined earlier, there are binding ceilings for a three-year period.

Two perspectives oppose each other in deciding the appropriate time horizon for the expenditure ceiling. On the one hand, a certain distance in time between the decision on the ceiling and budget negotiations can avoid a situation where the expenditure ceiling is set at an excessive level as a result of an unwillingness to make prioritizations. A minimum requirement is that the decision on the ceiling is made before—rather than during or, in the worst case, after—budget negotiations. On the other hand, the uncertainties in the macroeconomic and fiscal forecasts, on which the ceiling is calculated, increase with the time horizon. In particular, it is generally difficult to make a qualified assessment of the cyclical position of the economy far in advance. By setting a binding restriction on expenditure in the medium term, there is a risk that the level of the ceiling will become inconsistent with macroeconomic development and fiscal objectives.

The construction of the ceiling, and the choice between a fixed and a rolling ceiling, establishes the framework for fiscal policy formulation. A fixed multi-year ceiling, covering the years that the government will remain in power, outlines the overall fiscal policy envelope. Such a ceiling can avoid annual discussions between factions within the government with diverging views on the size of the government. The alternative approach of setting ceilings on a rolling basis, i.e., adding a new annual ceiling every year, allows for more discretion in the medium term, but means that ceilings will be set beyond the current government term. For an incoming government, with a policy agenda that differs substantially from that of the previous government, this may not be acceptable.

#### **F. Numerical Definition—Growth Rate, Percentage of GDP or Absolute Figure**

The size of the budget is ultimately a political decision, reflecting the ideological orientation of the existing government and parliament. From this perspective, there can be no uncertainty that the level of expenditure—and consequently the level of the expenditure ceiling—is under the complete discretion of the government and parliament. The supreme fiscal authorities always retain the right to expand or reduce the government sector. However, assuming that the government intends to follow a particular path for the development of public finances, it may be meaningful to clarify the principles according to which the expenditure ceiling is calculated. Perhaps somewhat surprisingly, none of the three countries explicitly present the method for calculating the ceiling.

From the perspective of ensuring fiscal sustainability, the most appealing approach is to explicitly establish the relationship between expenditure under the ceiling, revenue, and the

targeted fiscal balance or debt. An expenditure ceiling for the year  $t+n$   $\hat{E}_{t+n}$ , consistent with a forecast for total government revenue  $R_{t+n}$  and a targeted fiscal balance  $B_{t+n}^T$ , could be expressed:

$$\hat{E}_{t+n} = R_{t+n} + \Delta T_{t+n} - B_{t+n}^T - E_{t+n}^{OC} \quad (1)$$

where  $\Delta T_{t+n}$  is the effect of the tax reforms not included revenue forecast<sup>22</sup> and  $E_{t+n}^{OC}$  is forecasted government expenditure outside the ceiling. To avoid procyclicality, it is conceivable to make a full or partial structural adjustment of the targeted fiscal balance to arrive at an expenditure ceiling which takes into account departures from full employment and production levels. If the ceiling is calculated in this fashion, increase over time can be presented as:

$$\dot{\hat{E}} = \dot{R}_{t+n} + \Delta T_{t+n} - \dot{E}_{t+n}^{OC} \quad (2)$$

On way of expressing this is to say that ceiling-restricted expenditure can be increased by the increase in revenue to the extent that this is not needed for expenditure items outside the ceiling.

Explicitly linking the calculation of the expenditure ceiling to fiscal forecasts—and if the cyclically adjusted targeted balance is used, also to an assessment of the output gap—reduces discretion over fiscal policy in a manner that may be politically unacceptable. Although a qualified assessment of the fiscal sustainability of the expenditure ceiling may provide the basis for the ceiling, the government and parliament may not want to institutionalize a purely technical methodology.

A second reason not to formally tie the calculation of the ceiling to the above formula is that revenue forecasts may be biased or volatile. If this is the case, a reliance on medium-term projections for revenue may not generate the necessary stability. Additionally, the uncertainties involved in setting a balance target on an annual basis—as discussed in Section II A, *Why an Expenditure Ceiling?*—suggests that there could be practical difficulties in using the above methodology.

An alternative approach could be to define the expenditure ceiling in terms of a constant ratio to GDP, in which case the annual increase in the expenditure ceiling would simply amount to

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<sup>22</sup> The theory of tax smoothing would imply unchanged tax policies. It is hardly reasonable to disregard the possibility of changes in the tax system when formulating the model for calculating the expenditure ceiling, however.

forecasted GDP growth. In order to avoid procyclicality in the calculation of the expenditure ceiling, potential, rather than actual, GDP could be used.

$$\hat{E}_{t+n} = \beta \times GDP_{t+n}^{POT} \quad (3)$$

If employed strictly, such a methodology would still make the calculation of the ceiling a matter of technically interpreting forecasts, and would not leave any room for political intervention. If certain assumptions regarding the composition and dynamics of public finances are fulfilled, and if the GDP projections do not contain a bias, the potential problems outlined above could be avoided. Naturally, provided that the ratio of the ceiling to GDP is maintained at the same level,  $\beta$  has to be set at a time when the structural fiscal balance is at the targeted level, *i.e.*, structural revenue and expenditure are in harmony with one another. Changes in tax policies would require a revision of the ratio  $\beta$ . The model assumes that the tax revenue grows proportionally with GDP. In a situation where the composition of GDP changes, this condition will likely not be met. There is also an assumption that expenditure outside the ceiling is constant.

Yet another approach is to set the ceiling in terms of a constant rate of expenditure growth—either in real or nominal terms—independent of revenue growth or GDP growth.

$$\dot{\hat{E}} = \phi \quad (4)$$

Under the assumption that GDP grows at a constant rate, this is identical to maintaining a constant ratio between the ceiling and GDP. Allowing the ceiling to increase at a pre-determined constant rate has an appealing simplicity, and creates a high level of predictability in the amount of resources that will be allocated to government expenditure.

## G. Legislative Status

In order for an expenditure ceiling intended to promote fiscal discipline to be effective, it is crucial that there is a firm understanding of, and commitment to, the fiscal framework among political decision-making bodies. Any arrangement that is not perceived as serving the interest of the government and parliament will inevitably be circumvented. Designing a framework which is both fiscally stringent and politically acceptable is perhaps the biggest challenge in setting up fiscal rules.

Intuitively, it would seem that compliance with an expenditure ceiling would go hand in hand with an elevated legislative status, and that there would be a case for having the fiscal framework enshrined in legislation, such as the organic budget law. In addition, given the short-term pressure to expand policies and increase expenditure, it would appear that severe

legal sanctions could deter non-compliance. The fiscal frameworks in Finland, the Netherlands, and Sweden do not support this hypothesis, however. In all three countries, the expenditure ceiling has the status of a political commitment, and there are no predefined sanctions in the event of a violation.

In the case of an expenditure ceiling, legal provisions can be one way for the government and parliament to manifest their commitment to fiscal discipline. In the absence of political support for the fiscal framework, however, it is doubtful that legislative status will have any impact on actual policy formulation.

### **III. FINLAND**

Finland introduced a system with multi-annual expenditure ceilings in 2003. For more than ten years prior to this, Finland had operated a system of annual expenditure limits to guide the budget preparation process. The narrow coverage, frequent revisions, and short time horizon of these expenditure limits did not give sufficient support to the budget process, and public expenditure increased gradually during the latter half of the 1990s and the beginning of the 2000s. A more comprehensive and rigorous fiscal framework was considered necessary to ensure the sustainable development of public finances.

At the recommendation of a Ministry of Finance working group, the coalition government coming into power in the spring of 2003 adopted a set of fiscal policy targets, including real ceilings on noncyclical central government primary expenditure for all four years of the electoral period 2004–2007. The explicit objective was to limit the growth of expenditure, which would contribute to an overall objective of a reduction of the ratio of government debt to GDP. The experience with the fiscal framework has been positive, and procyclical pressure on expenditure during recent years' cyclical upswing has been kept at bay. The new government, which assumed power in April 2007, has decided to maintain the expenditure ceilings regime, but has introduced some changes to further increase the flexibility of the system.

#### **A. Comprehensiveness**

The expenditure ceiling is defined narrowly, covering some  $\frac{3}{4}$  of the central government budget. By insulating the ceiling from variations in interest payments, the effects of cyclical fluctuations, variations in the volumes in social security systems, old-age pension payments, certain expenditure on infrastructure investments, and expenditure variations not affecting the general government balance, the government is able to avoid many of the potential adverse effects associated with medium-term expenditure ceilings. At the same time, the construction of the ceiling is complex, and does not readily lend itself to outside verification. The decision on the expenditure limit is not at the same time a decision on aggregate

expenditure and the tax wedge in the economy. Leaving a significant part of central government expenditure outside the ceiling may also limit the ceiling's effectiveness in enforcing fiscal discipline, as several items can grow without explicit restriction.

### **Interest Payments**

Interest payments are excluded from the expenditure ceiling. The justification has been that interest payments tend to be unpredictable in the short term for reasons not related to the government's fiscal policy. As illustrated by the upward revision of forecasted interest expenditure for 2011 by EUR 90 million between March and May of 2007,<sup>23</sup> with a budget margin under the ceiling of EUR 101, an inclusion of interest payments under the ceiling could have a significant effect on fiscal policy. The Ministry of Finance also points out that reducing the cost and risk of servicing the government debt may require the Treasury to restructure the debt in a way that would increase expenditure in the short term, but would be expected to lead to lower average expenditure over the medium to long term.<sup>24</sup> For example, in recent years there has been a shift into debt instruments with a shorter maturity, which on average is expected to reduce effective interest rates, but at the same time increase volatility. By excluding interest payments from the debt, possible perverse incentives for effective debt management are eliminated.

Following the fiscal crisis in the first half of the 1990s—when the ratio of debt to GDP rose from 16.9 percent in 1991 to 67.1 percent in 1996—the government has been successful in bringing down the level of debt to more manageable levels. During the previous electoral period, debt to GDP ratios shrunk from 43.4 percent in 2003 to 32.1 percent in 2007. Since interest payments are excluded from the ceiling, the fall in interest payments has not created additional room for expenditure in the short to medium term. Analogously, interest payment variations caused by changes in the interest rate on the government debt do not affect the room under the ceiling.

### **Noncyclical Entitlements and Old-age Pensions**

The majority of non-employment-related benefits are organized in the Social Insurance Institution (KELA), which is separate from the budget.<sup>25</sup> Consequently, it is the central government contribution to the benefit systems administrated by this institution, rather than the actual entitlement payments, that is included under the ceiling. The guarantee payments

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<sup>23</sup> Ministry of Finance (2007c), p. 8.

<sup>24</sup> Ministry of Finance (2007a), p. 80.

<sup>25</sup> These include conscript benefits, rehabilitation, various support for parents and children, financial aid for students, income related sickness allowance, medication, dental care, survivors' benefits, housing allowance and occupational health care.

supplementing employers' and employees' contributions to national pensions, unemployment allowances, and housing allowances are excluded from the ceiling. Earnings-related pensions—except civil servant pensions—are organized into separate funds, and the pension payments from these funds are not included under the ceiling. Civil servants pensions are paid from the state budget, with a partial contribution—40 percent of the annual pension payments—to the budget from the State Pension Fund. Consequently, civil servant pensions are fully included under the expenditure ceiling.

Through increases in the central government's contributions, an increase in the number of beneficiaries in entitlement systems has a direct impact on ceiling-restricted expenditure. There is evidence that the volumes in non-employment benefit systems vary with the cycle in Finland.<sup>26</sup> If this is an indication of a covariance between unemployment and disability—in the sense that the same individuals move between various benefit systems—including expenditure for non-employment benefits while excluding employment benefits may create incentives to shift disability beneficiaries to the unemployment scheme.

### **Cyclically Sensitive Items**

To ensure that government expenditure is able to counterbalance cyclical variations in production and employment, items considered to be cyclically sensitive have been excluded from the ceiling. In an economic downturn, this allows all automatic expenditure stabilizers to work without restriction—without the need to make compensatory cuts in other expenditure items to comply with the ceiling. Consequently, aggregate demand is stimulated and the return to potential GDP levels is accelerated. During favourable economic conditions—such as the past years' cyclical upswing—falling expenditure for cyclical items does not open up any new room under the ceiling, and does not create opportunities to initiate new expenditure measures. The principle of excluding cyclically sensitive expenditure from the ceiling has been reaffirmed by the government that took office in 2007, and the comprehensiveness of the ceiling has been adjusted to further avoid cyclical factors from interfering with ceiling-restricted expenditure.

Because of their cyclical sensitivity, both unemployment benefits<sup>27</sup> and some non-employment benefits—such as housing allowance and pay security (income compensation to employees in the case of bankruptcy or insolvency)—are excluded from the ceiling. Changes

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<sup>26</sup> See Ministry of Finance (2007a), p. 73 and p. 75; and IMF (2007a).

<sup>27</sup> Compensation for income loss for unemployed are organized in three different systems in Finland: a basic unemployment allowance scheme, managed by the Social Insurance Institution (Kela); an earnings-related unemployment benefits scheme, organized in 36 unemployment funds separate from the budget—managed by the trade unions; and a labour market support scheme, primarily for participants in labour market programs. In addition to these three systems, there are certain targeted benefits for low-wage individuals and certain unemployed workers above a certain age.



in expenditure caused by discretionary changes in the regulation of benefits—either in the eligibility criteria or the level of compensation—are subject to the expenditure ceiling, however. Although this arrangement is conceptually appealing, and calculations of the discretionary expenditure effects are made, it is difficult to accurately distinguish cyclical effects from discretionary effects—particularly behavioral effects. Even without changes in the benefit systems, there may be changes in the structural unemployment level that make labor market policies unsustainable.<sup>28</sup> Excluding expenditure on unemployment—both through the organization of unemployment insurance system in funds separate from the budget and by explicitly exempting specific budget items—means that such a development will not be prevented by the ceiling.

In addition to income support to the unemployed, the government's labor market policies include programs to improve their qualifications. Certain expenditure for these programs is included under the ceiling, while other expenditure is not. As there is evidence that almost half of the long-term unemployed carousel between labor market programs and unemployment,<sup>29</sup> expenditure under the ceiling depends on which system is supporting the unemployed.

Although the unemployment benefits system, the social security systems, and the national old-age pension system all receive employer and employee contributions, the government has a subsidiary responsibility to ensure that sufficient funds are available for making the required payments. Such guarantee payments therefore vary according to the level of contributions—a factor influenced by economic activity. For this reason, the central government contributions to the old-age pension scheme, the unemployment funds, the incapacity benefits system, and the social assistance system are excluded from the ceiling. Changes in expenditure caused by modifications of the entitlement regulations are included under the ceiling. However, when the regulations governing employers' and employees' contributions change, their effect on the government's guarantee contribution is not included under the ceiling—as these are considered tax measures. On the other hand, following the changes in the expenditure ceiling regime introduced in 2007, the central government's contribution to incapacity insurance—which includes both income-replacement benefits and medical, dental, and medicine costs—was included under the expenditure ceiling, as the cyclical variance of this contribution is marginal.<sup>30</sup>

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<sup>28</sup> For a discussion on the structural unemployment levels in Finland, see Maiväli (2006).

<sup>29</sup> IMF (2007b), p. 5.

<sup>30</sup> As a result of changes introduced in 2006, the contributions from employers and employees are adjusted continuously to maintain a constant share of the costs of the sickness insurance. Consequently, the central government contribution is not affected by cyclical variations. Ministry of Finance (2007a), p. 70–72.

### **Non-distortionary Earmarked Revenue**

Budget expenditure funded by, and directly linked to, a specific non-tax contribution is excluded from the ceiling. The justification for this principle is that changes in revenue—and consequently also in expenditure—have no impact on the government balance, and should not affect the room under the ceiling.

Expenditure financed by revenue from betting activities and lotteries, and earnings of the national monopoly on gambling—the Slot Machine Association—are excluded from the ceiling. As specified in the Lotteries Act, any such revenue is earmarked for promoting sports and physical education, science, arts, and youth activities. Changes in revenue, which would be caused by increases or decreases in voluntary gambling activity, have a corresponding effect on expenditure, without any impact on the government balance.

Although the revenue collected from betting, lotteries, and the activities of the Slot Machine Associations is clearly not part of the tax system, and does not contribute to the tax wedge in the economy, it could be argued that it should still be subject to the principle of universality, i.e., that all revenue should go into financing all expenditure. By including this expenditure under the ceiling, the decision to designate certain revenue for a specific purpose is exposed and laid open to scrutiny in budget negotiations. A rapid fall in revenue could put pressure on the Government to provide additional financing to maintain the previous years' funding level.

An analogous situation occurs with budget expenditure financed from the EU budget. As payments are offset by corresponding revenues, and there is no impact on the government balance, this expenditure has been excluded from the ceiling. The required national co-financing is included under the ceiling, however. In addition to the neutrality of EU-financed expenditure on the government balance, there may be practical reasons to exclude these items from the ceiling. Although the total amount of resources available over a number of years can be determined with some accuracy, delays in the implementation of EU programs frequently occur, with the result that the expenditure for individual years differs from that which was forecasted.

A third item excluded from the ceiling is ministries' and government agencies' expenditure on value added tax, when this is appropriated as a separate item in the budget. Since any change in the administration's expenditure on value added tax will be accompanied by a corresponding change in revenue collection, there would be no effect on the government balance. According to the Ministry of Finance, this item has been difficult to accurately forecast, and erroneous projections have created risks of exceeding the expenditure ceiling. The main argument for excluding this budget item, however, has been to eliminate any bias against outsourcing, for which the administration has to pay value added tax. Only that expenditure on value added tax which has been separately specified in the budget is excluded from the ceiling. This amount is very small, however.

## Investment Expenditure

Expenditure on infrastructure investment is included under the ceiling. Limited room under the ceiling, together with uneven expenditure patterns for investment projects, has raised questions about how to best manage investment expenditure.<sup>31</sup> Although the government has opted to maintain investment expenditure on a cash basis under the ceiling, some flexibility between budget years has been introduced, as discussed in section E below.

If revenue from the sale of shares in government owned enterprises is exceptionally high, the Government can use a certain percentage of this revenue for expenditure outside the ceiling. Since the introduction of this clause, both the threshold revenue level and the percentage value have changed.<sup>32</sup> Expenditure funded by this revenue should be of a one-off nature—i.e., there should be no permanent increase in the expenditure level—and the full impact on all future years should be taken into account. If this requirement is not observed, there is a risk that the Government may enter into future expenditure obligations that will put pressure on ceiling-restricted expenditure. According to the rule, expenditure should be used for “expenditure-boosting expertise, innovation, and economic growth, unless other reasons exist for not doing so.” Thus far, expenditure has primarily been directed toward investments and activities promoting research and development.

Financial investment, which merely consists of converting one type of asset into another type of asset, is not considered to be expenditure, and is not included under the expenditure ceiling. According to the rule governing the use of revenue from the sale of government-owned shares, such financial disinvestment can be used for investment in non-financial assets outside the expenditure ceiling. However, such a transaction will reduce government net lending according to ESA 95, and could to some extent erode fiscal discipline.<sup>33</sup> Financial investment also includes loans provided through the Funding Agency for Technology and Innovation (TEKES). In the case that there is a default on such loans, they will be treated as direct subsidies, and classified as expenditure, which reduces net lending.

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<sup>31</sup> Ministry of Finance (2007a), p. 92.

<sup>32</sup> When the rule was introduced in 2003, 10 percent of revenue above EUR 500 million could be used for expenditure outside the ceiling. In 2006, this percentage was increased to 20. Under the new government, which took office in 2007, the rule has been redefined to a maximum of 25 percent of revenue exceeding EUR 400 million, but no more than EUR 150 million.

<sup>33</sup> The government has announced that the central government deficit should not exceed 2.5 percent of GDP, Ministry of Finance (2007d), p. 9.

## B. Inflation Adjustment

The expenditure ceilings for the four years are established in real terms. In a government decision in March every year, the ceilings are converted into the upcoming year's price level using an updated deflator of the central government price index. At this time, the government also makes any technical adjustments of the ceiling needed to neutralize changes in the structure of the budget.

By using a price index of central government expenditure, which consists of a *weighted average* of various price and wage indices,<sup>34</sup> the government is able to adjust the ceilings by the actual impact that inflation has on ceiling restricted expenditure. Unintended expansion or reduction of the real room under the ceiling—which would be the result of using one single inflation index to adjust the heterogeneous inflationary development of government expenditure—is largely avoided. The assumptions underlying the various inflation indices are presented in an appendix to the annual government decision on the expenditure ceilings. The government does not disclose the weights that are placed on these indices, and it is not possible to replicate the inflationary adjustments.

## C. Mechanisms to Manage Expenditure Fluctuations

Even when expenditure that is considered to exhibit short-term volatility is excluded, expenditure may increase more rapidly than the projections underpinning the ceilings. As mentioned above, the ceilings for 2008-2011 include a margin that can absorb an unexpected growth in ceiling-restricted expenditure. The margin under the ceiling increases slightly for the latter years in the period, a reflection of the greater uncertainty for those years.

In addition to the explicit recognition of the need for a margin under the ceiling that can absorb non-discretionary and discretionary expenditure increases, several changes have been made to increase the flexibility of the expenditure ceiling compared with the previous period. In order to bridge the transition from one fiscal year to the next, EUR 100 million can be used for expenditure on top of the ceiling for the following year. This provision will diminish the government's incentive to maximize expenditure under the ceiling in a particular year.

The government has also introduced the possibility of offsetting changes in the ceiling between two years to adjust for changes in large payments. Such technical adjustments will have an impact on the government balance for individual years, but not for the entire period

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<sup>34</sup> The central government price index includes: pension indices, the consumer price index, the state subsidy index, the building cost index, domestic and EU GDP indices, the price index for domestic supply, central government pay raises, and changes in social security contributions.

covered by the expenditure ceilings. The ability to adjust the ceilings for deferred payments could mitigate a significant part of the problems associated with investment expenditure.

#### **D. Time Horizon**

Expenditure ceilings are set for the four years of the government's term in office. A new government is, therefore, not constrained by any ceilings established by a previous government. Apart from the inflationary compensations and any technical adjustment to equalize changes in the budget structure, ceilings are not revised once established. This stands in contrast to the previous order, where the annual revision of the aggregate expenditure level enabled procyclical policies, and proved to be incompatible with firm fiscal discipline.

Over a four-year time horizon, there are substantial uncertainties about the development of government expenditure. Binding restrictions set far in advance could turn out to be either too lax or too restrictive for the policies that the government wants to pursue. Eliminating the effects of inflation surprises and excluding a number of expenditure items that tend to fluctuate in the medium term has done much to mitigate the problem of uncertainties.

The government's decision on the expenditure ceiling also includes an allocation of expenditure to administrative branches for each year of the ceiling. These allocations include both expenditure covered by, and excluded from, the aggregate ceiling, and therefore indicates the government's overall policy direction. The allocation to administrative branches is only tentative, however. For the upcoming budget year, the final allocation is set in the Budget Bill submitted to parliament in September, and for the years beyond, the government presents an updated division in future expenditure ceiling decisions and Budget Bills. This reflects the fact that the purpose of the system is not to limit the increase of any specific appropriation, but to focus on overall expenditure and leave the detailed distribution to be defined in individual budgets.

#### **E. Numerical Definition**

The government does not present any explicit relationship between the expenditure ceiling and other fiscal parameters affecting the central government or the general government balance. The government decision concerning the principles for the expenditure ceiling states that the ceilings should take into account the appropriations necessary to execute the policies of government programmes or other government decisions.<sup>35</sup> In the government decision on

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<sup>35</sup> Government decision, issued on 24 April 2003, on the principles of formulating central government spending limit proposals, budget proposals, and operating and financing plans.

the expenditure ceilings for the period 2008–2011, the ceilings are justified in terms of the increased expenditure necessary to achieve the policies outlined in the government programme. Compared with 2007, the ceilings for the period increase by EUR 1.3 billion in real terms, which is approximately 4.0, or a close to 1.0 percent increase per year on average.

In addition to estimated expenditure for announced policies, a planning margin of EUR 300 million—approximately 0.9 percent of the ceiling—has been included in the annual ceilings for 2008–2011. This margin is intended for discretionary expenditure increases in supplementary budgets.

Since the expenditure ceilings are set in real terms, and a central government price index is used as the deflator, the development of central government expenditure expressed as a ratio of GDP will not necessarily follow the real growth of the expenditure ceiling. Over the first period with expenditure ceilings, the central government price index grew more rapidly than the GDP deflator, allowing the ratio of expenditure to GDP to increase. To the extent that this development is unintended, it is possible to adjust the real level of the ceiling at the outset of a new four-year period. Radical changes in the level of expenditure from one year to another may not be feasible, however.

#### **F. Legislative Status**

There is no legal requirement for the Government to present expenditure ceilings for years other than the upcoming budget year. The regime with medium-term ceilings is a voluntary restriction that the Government has placed on itself. The principles along which these ceilings are constructed are determined and announced by the government. The medium-term ceilings are determined through a government decision, and are not formally approved by Parliament.

There are no formal sanctions for exceeding the expenditure ceiling. Compliance with the ceiling is primarily monitored by the Ministry of Finance. Given the complexities of identifying which expenditure items—or in some cases, which parts of expenditure items—are included under the ceiling, together with the opaque adjustment for inflation, it is difficult for an outside institution to verify conformity with the ceiling.

The political commitment to compliance with the ceilings is high. Performance against the expenditure ceilings is discussed in media, and in the political debate.

### **IV. THE NETHERLANDS**

In response to deep and prolonged fiscal difficulties, a new fiscal framework was adopted in the Netherlands in 1994. Although it has been subject to some revisions since its

introduction, the framework has remained essentially intact, and enjoys wide support across political parties. One of the fundamental pillars of the Dutch fiscal framework is a regime with *comprehensive real multi-year expenditure ceilings*, anchored in a coalition agreement between the parties forming the government. By quantifying the government's policies for the upcoming four years—not just in terms of total expenditure, but in terms of allocation to main sectors as well—the expenditure ceilings provide stability and predictability to the annual budget process. Expenditure ceilings have also supported the effort to ensure fiscal sustainability, and have restrained expenditure growth during buoyant economic periods.<sup>36</sup>

### A. Comprehensiveness

The expenditure ceilings are widely defined, covering virtually all expenditure of the central government sector. Owing in large part to historical factors, the central government in the Netherlands is divided into three sub-sectors: 1) the core government sector; 2) the health care sector; and 3) the social security and labour market sector. In line with this structure, the aggregate ceilings for each of the four years in the coalition agreement are broken down into sub-sector ceilings. Initially, the government expressed the ambition that the sub-ceilings should be binding, and that offsetting shifts between sub-sectors should not be allowed. Expenditure projections indicating that there was a threat of exceeding a sub-ceiling would require compensating expenditure cuts *within* that sub-sector. A margin between a sub-ceiling and sub-sector expenditure would result in an improved budget balance or create scope for tax reductions. In reality, as early as the first period of 1994-1997, expenditure overruns under one sub-ceiling were compensated for by lower expenditure under other sub-ceilings, although the aggregate ceiling was still observed. During the second coalition government's term, 1998-2001, the ability to make offsetting shifts between sub-sector ceilings—subject to compliance with the aggregate ceiling—was officially recognized, and overruns in the health care subsector were compensated for by lower expenditure in other areas, primarily the social security and labour market sectors. It is the intention that such compensations only be made for cost overruns incurred through existing policies, and not to cover expenditure for new policy proposals. Such new expenditure must fit under the original sub-ceilings.

### Interest Payments

Up until 2008, interest payments on government debt were included under the aggregate expenditure ceiling, covered by the sub-ceiling on the core government sector. Although the reduction in debt and interest expenditure would—at least in part—seem attributable to the

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<sup>36</sup> See OECD (2006) for a discussion on the impact of the fiscal framework on the effort to ensure sustainability of public finances.

fiscal framework in general<sup>37</sup>, it is an open question whether the inclusion of interest rates under the ceiling has by itself promoted a debt-reducing fiscal policy. Following the recommendation of the Advisory Group for Budgetary Principles' report from June 2006,<sup>38</sup> interest payments have been excluded from the ceilings for the period 2008–2011, the argument being that this type of expenditure is volatile and could be procyclical.<sup>39</sup>

Since the introduction of the fiscal framework, there have been both a dramatic drop in the gross debt—from 77.7 percent of GDP in 1993 to 46.8 percent of GDP in 2007<sup>40</sup>—and a decline in the nominal interest rate on the debt.<sup>41</sup> There has been a corresponding drop in the ratio of interest payments to general government expenditure from 10.7 in 1993 to 4.8 in 2007.<sup>42</sup> To the extent that this development has been unexpected, in the sense that it was not reflected in the forecasts underpinning the expenditure ceilings, the declining interest payments have freed up room for other expenditure.

Up until 2007, cautious macroeconomic assumptions were used when formulating fiscal policy. By consciously underestimating GDP growth—and consequently also real interest rates—the government introduced an asymmetric risk of interest rate surprises. The bias in debt service resulting from cautious macroeconomic assumptions has been offset by other factors, and has not put strain on interest expenditure. The use of cautious assumptions has been discontinued in the coalition agreement for 2008–2011.

### **Noncyclical Entitlements and Old-age Pensions**

One of the most generous systems of disability benefits of OECD countries,<sup>43</sup> numerous other legislated benefits—such as support to university students and housing support to low income groups—and a steady upward trend of entitlements beneficiaries has strained public finances in the Netherlands. As gross expenditure of all entitlements is included under the

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<sup>37</sup> IMF (2005), Bos (2007), OECD (2006).

<sup>38</sup> Such advisory groups are appointed by the Minister of Finance roughly one year in advance of an election, and their task is to analyse the fiscal development and produce a report with recommendations for the incoming government.

<sup>39</sup> Netherlands, Ministry of Finance (2007).

<sup>40</sup> General government consolidated debt according to ESA95 (EMU debt). Dutch State Treasury Agency (2007), [www.dutchstate.nl](http://www.dutchstate.nl).

<sup>41</sup> The interest development is partly explained by lower inflation, and partly by a lower risk premium on government interest rates. “...sharp fall in interest rates—and therefore a fall in the costs of debt service—enabled the previous administration to accommodate notorious spending overruns in the health care.” van Ewijk and Reininga (1999).

<sup>42</sup> Central Planning Bureau (2007), [www.cpb.nl](http://www.cpb.nl).

<sup>43</sup> OECD (2004).



expenditure ceiling, the Government has been forced to intervene with compensatory measures—either by improving the enforcement of the existing system, proposing changes in the entitlement legislation, or by reducing expenditure for other purposes—in order to comply with the ceiling in the face of growing entitlements expenditure. Through a series of measures intended to tighten the welfare system, the government has drastically reduced the number of individuals supported by disability benefits, and managed to diminish expenditure on social security.<sup>44</sup>

There is some evidence that social security expenditure in the Netherlands is countercyclical, and that more individuals apply for disability benefits during cyclical upturns than cyclical downturns. Social security benefits have thus been described as a luxury good, implying that affluent economic conditions make people prone to take advantage of these systems. A complementary explanation is that although the volumes in individual transfer schemes fluctuate in the short term, the total number of individuals supported by government transfers tends to move more slowly. The various benefit systems are to some extent communicating vessels, and the same individual moves between unemployment and disability benefits. By including all transfer systems, the ceiling captures the expenditure development of the government's welfare systems, irrespective of how individuals are supported.

The single most important challenge in to public finances in the Netherlands is the cost of ageing. By including under the ceiling all expenditure affected by a changing demographic composition of the population—including old-age pension expenditure—the sustainability of government finances is exposed to scrutiny and incorporated into the fiscal framework.

### **Cyclically Sensitive Items**

The expenditure ceiling in the Netherlands covers gross expenditure for unemployment benefits. In a cyclical downturn—with increasing unemployment—pressure will be put on expenditure, and the room under the ceiling will be squeezed. Conversely, a buoyant economy will create scope for additional expenditure as the unemployment benefits decrease. As discussed above, in cases when unemployment and inflation move in opposite directions, such procyclicalities are mitigated under nominal ceilings. In the case of the Netherlands, where the real ceilings are translated into nominal ceilings each year by using an updated deflator, such dampening does not take place.

The high sensitivity of government expenditure to cyclical conditions in the Netherlands would suggest that the inclusion of unemployment benefits under the ceiling would lead to

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<sup>44</sup> Ministry of Finance (2006).

procyclical pressures.<sup>45</sup> According to OECD estimates, the elasticity of current primary expenditure with respect to the output gap is -0.23, which places the Netherlands well above both the OECD average of -0.10 and the Euro area average of -0.11.<sup>46</sup> This estimate only takes into account the impact of unemployment benefits resulting from a departure from potential GDP. To the extent that there are other cyclically sensitive expenditure items, this elasticity could both be underestimated and overestimated.<sup>47</sup>

Since the introduction of the expenditure ceilings regime in 1994, there has been a dramatic drop in unemployment in the Netherlands. In 1994, the unemployment level was 6.8 percent, and in 2001 the figure was 2.2 percent. The fall in unemployment created room under the ceiling that could be used to offset increasing expenditure in other areas, notably growing health care expenditure. As a result of the cyclical downturn in 2002, unemployment increased by 2 percentage points to 4.7 percent in 2005, which put pressure on expenditure. The Government was able to manage this brief economic downturn within the existing expenditure ceilings, partly through the introduction of a small margin under the ceiling in 2002. Since then, unemployment has turned around, and is estimated to be approximately 3.2 percent in 2007. The inclusion of unemployment benefits under the ceiling does not appear to have been a prohibitive obstacle for running countercyclical fiscal policies, despite substantial cyclical swings.<sup>48</sup> In the most recent review of the fiscal framework, there has been an attempt to limit the scope for using the room under the ceiling created by an economic upswing, by stipulating that it cannot be used for structural measures. In practice, however, it may prove to be difficult to identify to what extent an unexpected room under the ceiling is structural or cyclical.

### **Non-distortionary Earmarked Revenue**

The expenditure ceiling is described as being set in terms of *net expenditure*, which means that certain non-tax revenue—such as school fees, various fines, dividends from the central bank and state corporations, and interest received—directly offsets expenditure, rather than

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<sup>45</sup> During the period 1998–2001, the expenditure room created by favourable economic conditions was largely used to make discretionary expenditure increases, Heeringa and Lindh (2001), p. 502. Conversely, the cyclical downturn in 2002 put upwards pressure on the expenditure for unemployment benefits, OECD (2006).

<sup>46</sup> Girouard and André (2005).

<sup>47</sup> The previous expenditure elasticity for The Netherlands by OECD was -0.70, and the main reason for the revision in 2005 was that only unemployment benefits were included in the new technique for calculating the sensitivity of expenditure. This suggests that an elasticity of -0.23 would be on the low side. See Girouard and André (2005), pp. 20–21, and OECD (1999). As pointed out by van Ewijk and Reininga (1999), however, there is evidence that there is a covariance between unemployment and the number of recipients of social security payments. This would diminish the procyclical swings in the room for expenditure over the cycle, providing an argument that the elasticity is overestimated.

<sup>48</sup> OECD (2006).

being included under the revenue side of the budget. An increase in this type of revenue allows for extra expenditure without burdening the ceiling. Conversely, a shortfall in projected revenue requires expenditure cuts to maintain the same margin under the ceiling.

Allowing certain transactions to be reported on a net basis is considered acceptable under the Dutch fiscal framework, and has not met with any challenge. The justification for such practice is to create incentives for the administration to provide demand-driven services. The extent of such non-tax revenue is limited.

### **The FES Fund**

Following a gradual decline in government investment in infrastructure in the 1970s and 1980s, the government established the Economic Structure Improvement Fund (FES) in 1993. This fund, primarily financed through natural gas revenue,<sup>49</sup> was intended for investments of national significance. According to the government, the fund was aimed at turning assets under ground into assets above ground. In the first years investment was almost exclusively directed towards infrastructure in the transport sector. More recently, investments in knowledge, innovation, and the environment have been financed through the fund. The criteria for expenditure under FES are not clearly defined, however, as illustrated by the use of the fund to finance expenditure resulting from abolishing certain school fees.

Expenditure from the FES is outside the ceilings, and the large inflows resulting from high energy prices in recent years have put upward pressure on expenditure. Although investments undertaken by the fund are subject to a cost-benefit analysis by the CPB, concern has been raised over the quality of the FES-financed projects. Recently, a principle was established that medium-term plans for investment financed by FES have to be set at the beginning of a government term.

### **B. Inflation Adjustment**

The expenditure ceilings, established in the coalition agreement, are set in real terms. Each year, the real ceiling is translated into a nominal ceiling, using an updated estimate of inflation. Unexpected changes in the inflation level therefore have limited impact on the expenditure room under the ceiling, as the binding restriction is adjusted in line with the nominal change of expenditure. The use of real ceilings does not completely eliminate the effect of inflation on government expenditure, however.

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<sup>49</sup> A second source of financing is made up of the reduction in interest resulting from the amortization of government debt from the sale of equity in public corporations.

Although a significant part of government expenditure is affected by price and wage increases, the inflation effect is not uniform across all items in the budget. Expenditure sensitive to wage inflation—e.g., the civil service wage bill and wage-indexed transfer payments—will typically develop at a different pace than expenditure on goods—e.g., the purchase of military equipment. In addition, a number of items in the budget are set in fixed nominal terms, and are not affected by inflation in the medium term.

Depending on the choice of deflator, the translation from real to nominal ceilings will have an impact on the margin under the ceiling. Items in the budget that inflate more rapidly than the deflator will tend to crowd out expenditure under the ceiling, while the items that are not sensitive to price and wage increases will increase the margin. The rapid decrease of the unemployment rate in the latter part of the 1990s created labour shortages and put upward pressure on the wage level. Nominal wage inflation—and, consequently, expenditure sensitive to the development of the wage level—rose more rapidly than the GDP deflator, putting pressure on ceiling-restricted expenditure in real terms.<sup>50</sup> These “terms-of-trade effects” have been recognized by the government, and following the recommendation of the Advisory Group for Budgetary Principles, the deflator was changed from the GDP deflator to the National Expenditure deflator in 2002. Because of this change, variations in import and export prices no longer have an impact on the inflation adjustment of the expenditure ceiling in the short term, which to some extent reduces terms-of-trade effects. By defining the deflator in the fiscal framework, and by assigning the task of calculating the deflator to the CPB, there are limited opportunities for the government to make annual revisions to create additional nominal room under the ceiling.

The final adjustment of the expenditure ceiling takes place in April of the current budget year, using an updated forecast of the deflator. Differences between actual inflation of national expenditure and the forecasted deflator are not adjusted for. The actual impact of such inflation surprises should be limited, however. The elasticity of government expenditure to current year inflation would typically be low, as the inflation adjustment of most government expenditure has already been determined.

### **C. Mechanisms to Manage Expenditure Fluctuations**

The comprehensive nature of the expenditure ceiling, combined with the four-year time horizon, imply that ceiling-restricted expenditure may deviate considerably from what was forecast when the coalition agreement was established. Unexpected cyclical developments, unforeseen variations in the number of individuals eligible for entitlements of various kinds, and possibilities of shifting appropriated funds between fiscal years<sup>51</sup> all create uncertainty of

<sup>50</sup> Ministry of Finance (2004).

<sup>51</sup> Departments are allowed to carry 1.0 percent of unspent appropriations over to the following fiscal year.

the actual expenditure outcome. In addition, differences between the actual impact of inflation on government expenditure and the inflation adjustment of the expenditure ceiling can create both a larger and a smaller room under the ceiling. The removal of interest payments from the ceiling reduces some uncertainty about the development of expenditure.

In the early years of the fiscal framework, characterized by strong cyclical conditions, the decreasing expenditure for unemployment benefits was used to finance new policy measures. This deteriorated the structural fiscal balance, and contributed to the rapid deterioration of public finances during 2002 and 2003.<sup>52</sup> In 2002 the government announced a principle that cyclical windfall gains on the expenditure side were not to be used for discretionary expenditure increases. This principle aims at avoiding procyclical fiscal policies in an economic upswing. The experience of the downturn in 2003, when the general government balance deteriorated rapidly and put the Netherlands in breach of the Stability and Growth Pact's deficit limit of 3.0 percent of GDP, also illustrated the risk of allowing temporary expenditure room for permanent policies.<sup>53</sup> The definition of what constitutes a cyclical windfall is not clearly defined, however, and is subject to interpretation by the Ministry of Finance.

Except for a small margin between the ceilings and projected expenditure that is set when the coalition agreement is established, the Dutch fiscal framework does not contain any explicit mechanisms to manage unexpected expenditure increases. Unless there is a decrease in expenditure on some other item, an upward revision of expenditure requires discretionary measures to stay under the ceiling. The use of cautious macroeconomic scenarios to set the first three coalitions agreements created a bias toward favourable cyclical surprises, alleviating some of the pressure under the ceiling in the cyclical downturn in the early years of 2000. This effect was to some extent offset by the negative bias in the assumptions for real interest rates and real wage increases. Higher than forecasted productivity increases also resulted in wage increases, which put pressure on both the government wage bill and wage-indexed benefits and entitlements. The increase in health care expenditure and disability payments in the periods of 1994-1997 and 1998-2001 was to a large extent offset by declining expenditure on unemployment benefits and interest payments, and did not require compensatory measures to remain in compliance with the ceilings. A more unfavourable development in the following period has strained the ceiling. The government has responded with a series of expenditure-reducing measures that include: tightening the social security system; introducing changes intended to reduce the number of individuals relying on

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<sup>52</sup> OECD (2004).

<sup>53</sup> OECD (2006), p. 57.

entitlement and increase the labour supply;<sup>54</sup> and to some extent by shifting expenditure to the FES fund outside the ceiling<sup>55</sup>.

The possibility of circumventing the expenditure ceiling by introducing new tax expenditure after the ceilings have been established has been recognized, and in principle the ceilings should be adjusted for any such substitutions between expenditure and revenue. The Netherlands have also introduced a set of criteria that have to be met by all new tax expenditure,<sup>56</sup> creating some barriers to using this escape route to avoid the expenditure ceiling.

#### **D. Time Horizon**

The four year horizon for the expenditure ceilings places a high demand on the Government's fiscal forecasting capacity. The ceilings are calculated in year  $t$  for the years  $t+1$ ,  $t+2$ ,  $t+3$  and  $t+4$ . Potential GDP growth and the output gap are estimated for all years in the coalition agreement<sup>57</sup>, which enables a forecast of cyclical revenue and expenditure. The uncertainty of these calculations increase with the time horizon, however, and cyclical surprises could strain the fiscal framework, as illustrated by the unexpected and sharp downturn of the economy in 2003. Given the difficulty of forecasting the cyclical position in a medium term perspective, the four-year horizon of the expenditure ceiling could limit the room for countercyclical policy on the expenditure side of the budget.

#### **E. Numerical Definition**

The fiscal framework does not contain any explicit formula for calculating the expenditure ceiling. The Government maintains its commitment to the criteria in the European Union's Stability and Growth Pact, which stipulate that general government net lending according to EAS 95 should be close to balance or in surplus, and should not exceed 3.0 percent for any given year. Given the sensitivity of public finances to cyclical variations, the Government estimates that it is necessary for the structural surplus to remain above 0.5 to 1.0 percent of GDP.<sup>58</sup> The Government strives for a structural surplus of 1.0 percent of GDP in 2011.<sup>59</sup>

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<sup>54</sup> OECD (2004).

<sup>55</sup> Bos (2007), p. 48.

<sup>56</sup> See van den Ende et al. (2004) for an overview of the treatment of tax expenditure in the Netherlands.

<sup>57</sup> See Ministry of Finance (2007), table 2.3.

<sup>58</sup> With an elasticity of the budget balance to the output gap of 0.53 (Girouard and Andre (2005)), a structural deficit of 1.0 percent of GDP would allow an output gap of up to 3.8 percentage points without violating the deficit limit of the Stability and Growth Pact of 3.0 percent of GDP.

<sup>59</sup> Ministry of Finance (2007).

In order to reach the targeted structural surplus, a cyclically adjusted expenditure ceiling has to be consistent with cyclically adjusted revenue. Since the coverage of the ceiling is narrower than the general government sector targeted by the balance objective, expenditure outside the ceiling—such as FES expenditure, local government expenditure, and, since 2008, interest payments—has to be brought into the calculation. In addition, ceiling-restricted expenditure is recorded on a cash basis, while the general government net lending is on an accrual basis. Certain adjustments are thus necessary in order to establish the correct relationship between the expenditure ceiling and the targeted surplus. An expenditure ceiling  $\hat{e}_{t+n}$  for year t+n, expressed as a ratio to GDP, which is consistent with a targeted general government structural surplus of  $\bar{s}_{t+n}$ , is given by:

$$\hat{e}_{t+n} = r_{t+n} - [\bar{s}_{t+n} (1 + \phi og_{t+n})] - e_{t+n}^{oc} - \gamma_{t+n} + \Delta t_{t+n} + m_{t+n} \quad (5)$$

Where  $r_{t+n}$  is forecasted general government revenue as a percentage of GDP, expressed in ESA 95,  $\phi$  is the balance elasticity with respect to the output gap,  $og_{t+n}$  the output gap for the year t+n,  $e_{t+n}^{oc}$  projected expenditure outside the ceiling,  $\gamma_{t+n}$  a factor adjusting for the difference in the accounting basis between ceiling restricted expenditure and ESA 95,  $\Delta t_{t+n}$  planned tax reforms, not included in the revenue forecast, expressed as a ratio to GDP, and  $m_{t+n}$  the contingency margin expressed as a ratio to GDP for the year t+n.

The Government does not explicitly express the above relationship among the expenditure ceiling and general government revenue, the targeted structural surplus, expenditure outside the ceiling, planned tax changes, and the budget margin as the method for setting ceilings. The coalition agreements outline the policies that have been agreed among the parties forming government, and the ceilings have to accommodate a realistic projection of the resulting expenditure.

*“The multi-annual expenditure ceilings are determined at the start of a new term of government. They are not simply policy ambitions about the size of public expenditure as a percentage of GDP without any clear and realistic underpinning. They are bottom-up calculated levels of expected public expenditure in constant prices. They reflect the coalition agreement and are intended to be realistic estimates of expected expenditure.”<sup>60</sup>*

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<sup>60</sup> Bos (2007).

## **F. Legislative Status**

The fiscal framework in the Netherlands is established in the coalition agreements between the parties forming government, and is not enshrined in any legislation. Parliament only approves the annual budget, and not the multi-annual expenditure ceilings. There is no indication that the expenditure ceilings' lack of formal legal status has diminished the government's commitment to compliance. The framework has—with some modifications—been intact since its introduction in 1994, which testifies to the support it has in the political establishment and among the general public. The aggregate expenditure ceilings have never been exceeded, although there have at times been reallocations between sub-ceilings. There are no predefined sanctions for violating the ceilings.

## **V. SWEDEN**

Since its introduction in 1997, the ceiling on central government expenditure has been an essential component of the fiscal framework in Sweden. By establishing a binding restriction on total expenditure well in advance of the start of the budget year, the government and parliament have enhanced their authority over a key fiscal parameter. In the ten years that the expenditure ceiling has been in existence, it has been firmly anchored in both the government administration and the political establishment.

There is wide consensus that the expenditure ceiling has been an effective tool to strengthen the budget process and stabilize government finances. The medium-term nature of the ceiling has also extended the outlook in budget matters. To ensure compliance with the ceiling, full medium-term forecasts of all ceiling-restricted expenditure are made on numerous occasions each year. Although this has significantly enhanced the understanding of the dynamics of government finances, uncertainties in the development of expenditure cannot be completely eliminated. On several occasions, negative surprises have put pressure on the ceiling, and the Government has been compelled to initiate expenditure-reducing measures.

### **A. Comprehensiveness**

The general principle for the expenditure ceiling is completeness, i.e., that all expenditure financed by central government revenue should be included under the ceiling. The decision on the level of the expenditure ceiling therefore reflects the necessary tax revenue and the tax wedge in the economy. In accordance with this principle, administrative expenditure, investment expenditure, Sweden's contribution to the European Union, grants to local government, and transfer payments are all subject to the aggregate restriction on expenditure. Interest payments on government debt are not included under the ceiling, however, since not only are they considered to be volatile and difficult to accurately forecast, it is not possible for the government to affect the level of the debt to any significant degree in the short term.



By including virtually all expenditure under the ceiling, the government may be forced to make cuts in existing policies or programs, should expenditure develop more rapidly than was forecast at the time the ceiling was determined. This means that good forecasting capacity is extremely important in order to ensure that the government constantly has an updated picture of the expenditure development in relation to the ceiling. By receiving an early warning about an alarming trend, the government is in a position to initiate appropriate expenditure-reducing measures.

In the budget document, the government presents the expenditure for 27 *expenditure areas* for the upcoming year and the two subsequent years. Consequently, the budget contains not only an aggregate ceiling for the three years but an indication of projected expenditure as well. This allocation of the aggregate ceiling to overall policies is in no way binding, however, and an updated allocation is made in the following budget.

### **Interest Payments**

The current fiscal framework in Sweden was introduced in the wake of a severe economic and fiscal crisis in the mid-1990s. With rapidly growing deficit and debt levels, combined with a deteriorating sovereign credit rating and escalating interest rates, a significant share of the budget was consumed by debt service payments. The lack of a direct relationship between the government's fiscal policies and its expenditure on interest payments *in the short to medium term* was cited as the reason for not including this expenditure category under the ceiling. Equally important has been the volatility in interest and exchange rates, which, given the large debt stock, generated substantial and unpredictable variations in debt service payments from one year to another. Including interest payments under the ceiling would have required a large buffer that could have absorbed these interest variations.

Gross debt has come down since then, and the case for excluding interest rates because of the uncertain expenditure impact is not as strong as when the ceiling was introduced. Nevertheless, volatility in interest and exchange rates is still sufficiently large to make an inclusion of interest expenditure unmanageable unless the margin between the ceiling and projected expenditure is increased. As discussed in section I F above, a larger contingency margin could introduce a risk of unwanted expenditure increase.

Changes in the composition of the debt are made occasionally, resulting in substantial variations in debt service expenditure from one year to another. As previously discussed, by excluding interest payments from the ceiling, incentives to take short-term considerations into account when evaluating the optimal debt management strategy are eliminated. In the current regime, there are few incentives to reduce gross debt—and as a result interest payments—by selling government property.

## **Noncyclical Entitlements**

One of the main challenges for the sustainability of government finances in the past decade has been the declining health indicators of the population. Long and short term sick leave and early retirement have been on an upward trend, putting upward pressure on expenditure for social security payments. As all expenditure for non-employment benefits is included under the ceiling, this development has forced the government to address the issue of rising entitlements.

Although difficult to forecast, the rising volumes in non-employment benefit systems have prompted increased efforts to explain the trend in the various transfer systems. As in both Finland and the Netherlands, there is evidence for a correlation between unemployment and the number of beneficiaries in disability systems. Transfer systems cannot, therefore, be seen in isolation, and the policies for the unemployment systems may have an impact on the non-employment benefit systems, and vice versa. This interdependence is another reason to include both employment and non-employment benefits under the ceiling.

The ceiling also covers expenditure for the old-age pension payments system, organized as funds outside the budget. This part of the pension system is fully funded by current social security payments. Expenditure for old-age pensions therefore contribute to the tax wedge in the economy and have a direct impact on general government net lending.

## **Cyclically Sensitive Items**

Labour market policies have traditionally been extensive, with generous benefits for the unemployed, a range of programs for retraining, and various forms of employment subsidies. For this reason, central government expenditure exhibits a high sensitivity to cyclical variations.<sup>61</sup> The inclusion of all expenditure related to labour market policies under the ceiling can put a limit on the scope for countercyclical fiscal policies during a downturn. Analogously, an unexpected decrease in the unemployment level can create room under the ceiling that could be used to increase expenditure. Unless properly managed, the expenditure ceiling could encourage procyclical policies.

The main justification for including the expenditure for labour market policies under the ceiling has been to avoid an unsustainable expansion of the system. Including labour market expenditure under the ceiling exposes the trade-off between these and other policies in the process of determining the government's priorities. Including this expenditure also creates a clear incentive for the government to closely monitor expenditure development, and react

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<sup>61</sup> According to OECD estimates, the elasticity of central government primary expenditure to changes in GDP is 0.15. As pointed out by Boije (2004), the effective elasticity may be higher if some semi-discretionary labour market policies are included.

with compensatory measures when there are signs that expenditure is increasing more rapidly than previously projected.

The ceiling has come under pressure on several occasions since its introduction in 1997—in part because of rising unemployment during cyclical downturns. Rather than leading the government to conclude that this expenditure item should be treated separately from the ceiling, this development has instead drawn scrutiny of the effectiveness of existing labour market policies. Reducing erroneous payments and diminishing the level of unemployment has been one of the central themes of the Government's agenda for the past years.

In addition to the automatic increase in expenditure for unemployment benefits, retraining and subsidized employment have been used to stimulate the return to full production and employment levels. Such labour market programs are discretionary, in the sense that an active initiative from the Government, and a decision by Parliament are needed to change the level of expenditure. Since the explicit objective of labour market programs is to address the unemployment level, the expenditure for these programs is to some extent related to cyclical factors.

### **Non-distortionary Earmarked Revenue**

The fundamental principle is that the budget should be on a gross basis. Revenue is presented on the revenue side of the budget, and expenditure on the expenditure side of the budget. There are, however, some exceptions to the principle. User fees collected by the administration for a voluntarily demanded service can be budgeted and accounted for on a net basis provided that the revenue goes exclusively towards covering the cost of that service. Although this means that the budget does not fully reflect total expenditure, there may be good reasons for allowing user fees for some activities to be used to cover costs.

In principle, the expenditure ceiling should be adjusted for *changes* in the budgeting and accounting treatment of non-tax revenue. Assuming that the ceiling has been approved under the assumption that certain non-tax revenue is treated on a gross basis in the budget and in the accounts, changing to a net treatment will create additional room under the ceiling. Existing ceiling should be neutral towards such changes, and there should be a corresponding downward adjustment of the ceiling.

The extent of net budgeting and accounting has been fairly stable, and changes in the reflection of non-tax revenue have rarely had an impact on the budget margin.

A related issue is how transactions between the national budget and the EU budget are treated. Sweden's contribution to the EU budget is fully included under the expenditure ceiling. Most payments from the EU budget go through the national budget, and are hence included under the ceiling. Such gross treatment does not create any problems as long as the

returning flows are correctly forecasted. There are large uncertainties in the actual payments of the structural funds, the social funds, and the agricultural support, as there are delays in the implementation of these programs.

### **Investment Expenditure**

Two different budgeting and accounting principles are used for investment expenditure. Investment in assets used by the government administration to produce public goods and services are financed by internal loans in the National Debt Office. This means that the appropriation covers the interest payments—determined by the National Debt Office based on the prevailing market rate—and amortizations according to centrally established depreciation plans. The assets concerned are typically of a limited value, and the depreciation periods are relatively short. Other assets—such as infrastructure—should be financed by appropriations. Parliament can, however, decide that certain infrastructure investments should be financed by internal loans.

Depending on how investments are financed, the impact on ceiling-restricted expenditure varies. By deciding that an investment project that was assumed to be financed by appropriations should be financed by internal loans, and thereby changing the principles for budgeting and accounting after an expenditure ceiling has been determined, it is possible to increase the room under the ceiling. The additional room is only temporary, however, and there is a corresponding increase in future ceiling-restricted expenditure.

### **B. Inflation Adjustment**

The medium-term expenditure ceilings are set in nominal terms, and there is no adjustment of the ceiling in the event that a more updated inflation forecast indicates a higher or lower inflation than that projected when the ceiling was determined. Although this introduces a degree of uncertainty about the room under the ceiling, it has been considered important to maintain nominal ceilings in order to ensure transparency. Defining the ceiling in nominal terms eliminates any ambiguity in the comparison between ceilings and expenditure forecasts. Nominal ceilings also eliminate the discussion about the appropriate methodology for making inflation adjustments, and avoid the risk of opportunistic changes in the deflator.

There are two reasons why, despite a nominal medium-term expenditure ceiling, the risk that unpredicted changes in the level of inflation will have a destabilizing effect on fiscal policy is limited. First, the elasticity of ceiling-restricted expenditure to general inflation is estimated to be close to unity,<sup>62</sup> although there is a certain lag in the impact of nominal price and wage

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<sup>62</sup> The analysis made in 2001 indicates that the elasticity of ceiling restricted expenditure to the GDP-deflator is between 0.86 and 1.00. Braconier (2001).

increases. Government consumption primarily consists of wages, which are determined in advance and mostly fixed in the short term. Most entitlements are indexed to the wage inflation two years prior to the budget year. The short-term impact of inflation is therefore limited. Changes in the inflation level will, naturally, be taken into account when determining the expenditure ceiling for the added third year, so it is only in the current year, the upcoming year, and the second subsequent year that unexpected inflation would have an impact on the real room under the ceiling.

The second reason why the risk of inflation surprises is limited comes from Sweden's relatively stable inflation level. The independent Central Bank operates without interference from the government, and has set an inflation target of 2.0 percent. A credible rules-based monetary policy has contributed to low and stable inflation, with few inflationary surprises since the introduction of the expenditure ceiling in 1997.

### **C. Mechanisms to Manage Expenditure Fluctuations**

The potential problems created by unpredicted changes in expenditure have prompted the government to carefully monitor ceiling-restricted expenditure—both for the current year and the three subsequent years in the medium-term framework. Although the government administration has developed a solid forecasting capacity, surprises cannot be eliminated completely. Apart from macroeconomic factors—such as changes in the unemployment rate and inflation—the number of individuals receiving payments from the various benefits systems can fluctuate from one year to another. Carryover provisions—through which government agencies can both use unspent appropriations from previous years and borrow against future years' appropriations—introduce uncertainty about what actual expenditure will be. Unexpected events, such as delays in the implementation of various programs, can occur. The wide comprehensiveness of the ceiling suggests that expenditure variations can be considerable.

The budget margin, i.e., the difference between the expenditure ceiling and forecasted expenditure, is the buffer that the government has at any given time for unexpected expenditure increases. Despite the obvious advantage of an unallocated margin under the expenditure ceiling, the government has not maintained a sufficiently large budget margin to absorb the estimated volatility of expenditure. A possible explanation for this seemingly irrational behaviour is a short time horizon in political decision-making. Insurance against an adverse development in the future may not be a sufficiently powerful argument in the face of significant pressure to expand policies. If this is a correct analysis of the political economy aspects of budget negotiations, budget margins should not be expected to solve the problem caused by medium-term expenditure volatility.

A budget at risk of exceeding a ceiling requires expenditure-reducing measures. For future years, it may be reasonable to achieve this by redirecting policies to a lower expenditure

path. The options for achieving substantial reductions in expenditure are more limited in the short perspective. Despite two across-the-board cuts of administrative appropriations—0.4 percent in 2002 and 0.6 percent in 2005—the Government has been reluctant to make changes to existing policies to reduce expenditure in the short term. Substantial changes are generally difficult to achieve in a short perspective, as there are implicit and explicit commitments that have to be honoured.

On repeated occasions, the Government has used its right to limit the use of appropriated funds. By restricting the amount under an appropriation—for example, appropriations for investments in infrastructure and purchase of military equipment—the government has been able effectively reduce expenditure for that year. Such limits only defer expenditure from one year to another, as full carryover of the unspent appropriations generally has been granted. The Government has also restricted the use of carryovers as a temporary measure to reduce expenditure for a particular year. More controversial was the conscious decision to delay a payment to the EU budget from December to January the following year.

Provided that the expenditure ceiling is consistent with the targeted surplus for general government finances, and that deferrals of expenditure between budget years cancel each other out, the use of a budget margin and expenditure limits to manage temporary fluctuations does not pose a threat to fiscal sustainability. It may be difficult to establish to what extent an expenditure increase is temporary—and therefore justified—and to what extent it is permanent and requires policy changes. This is particularly the case for labour market policies, and the appropriate reaction to high unemployment. The initiative to stimulate the labour market, launched in 2005, was taken despite insufficient room under the ceiling. Instead of reducing other expenditure items, the labour market package was predominantly financed through tax credits.

#### **D. Time Horizon**

The expenditure ceilings are set in a medium-term perspective, and the preparation of the budget for the upcoming year is subject to a ceiling set several years earlier. In the budget for year  $t+1$ , submitted to Parliament in September year  $t$ , the Government normally presents for the first time an expenditure ceiling for the year  $t+3$ . The budget also contains for parliamentary confirmation the ceilings for the years  $t+2$  and  $t+1$ , which have already been presented in earlier Budget Bills.<sup>63</sup>

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<sup>63</sup> Up until 2002, the ceiling for the third additional year was presented to Parliament for the first time in the *Spring Fiscal Policy Bill*, which is best described as a pre-budget statement, outlining the outlook for the medium to long term. In accordance with a Parliamentary decision, ceilings are now proposed in the Budget Bill in September.

On four occasions since the introduction of the fiscal framework, the government has neglected to present ceilings for the third additional year, and the expenditure ceilings have only covered two years. The justification given by the government for not proposing a ceiling has, among others, been that it has not been possible to forecast the room for government expenditure since the potential growth rate of the economy—and consequently the tax revenues—has been uncertain. Other times—such as when a new government came into office—the government has argued that there has been insufficient time to make a thorough analysis of the macroeconomic and fiscal development for the third year. The lack of a ceiling proposal for the third additional year could alternatively be interpreted as a resistance to make a binding commitment to the total expenditure level in the medium term. Sweden's experience with painful expenditure reductions caused by an unprojected deterioration of government finances could have influenced this decision.

On the one hand, a shorter time horizon could facilitate an adaptation of policies to prevailing macroeconomic and fiscal conditions, as argued by the government. Given the wide coverage of the ceiling and the ambitious labour market policies of the government, uncertainties over the medium term could prove to be difficult to manage. On the other hand, a shorter time horizon for the expenditure ceiling could have a negative impact on fiscal discipline. The government may want not only to maintain flexibility to adjust the room for expenditure to the cyclical position and possible random factors, but also to avoid difficult political negotiations caused by limited room for new reforms.<sup>64</sup>

A second problem with the lack of an expenditure ceiling for the third additional year has been that the outlook in the fiscal analysis becomes shorter. All existing policies and all new proposals are carefully evaluated to determine if they are consistent with the expenditure ceiling. Without the ceiling for the third year, the government has also refrained from presenting macroeconomic and fiscal forecasts for that year. Consequently, less attention has been given to analyzing the medium-term fiscal sustainability of government policies. A shorter planning horizon could therefore introduce fiscal risks, as the full deferred-impact proposed budget would not be sufficiently discussed.

### **E. Numerical Definition**

In order for the fiscal framework to generate the intended outcome in terms of improved fiscal sustainability, the relationship between expenditure and other fiscal parameters should be taken into account when determining the level of the ceiling. In this context it may be surprising that no explicit principles for calculating the expenditure ceilings are presented.

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<sup>64</sup> The minority Government in office until 2006 had to accommodate two smaller parties in order to secure support for the budget in Parliament.

Given the target of a general government annual surplus of 1.0 percent of GDP on average over the business cycle<sup>65</sup>, it is possible to derive the maximum level of ceiling-restricted expenditure. The level of central government primary expenditure consistent with the targeted general government surplus is given by:

$$\hat{E}_{t+n} = R_{t+n} - (0.01 \times GDP_{t+n}) - E_{t+n}^{oc} - \gamma_{t+n} + \Delta T_{t+n} \quad (6)$$

Where  $R_{t+n}$  is total general government revenue for year  $t+n$ ,  $E_{t+n}^{oc}$  is general government expenditure outside the ceiling, i.e. the expenditure for interest payments and local government expenditure,  $\gamma_{t+n}$  a correction factor for the difference in expenditure according to the cash accounting basis for ceiling-restricted expenditure and the accruals basis according to ESA 95, and  $\Delta T_{t+n}$  is planned tax increases not included in the revenue forecast. Considering that no forecast of the cyclical position of the economy is generally made in a three-year perspective, the structural and cyclical expenditure and revenue levels in this relationship coincide. Such a method of setting the ceiling—which would be expected to deliver a structural surplus of 1.0 percent of GDP—has not been followed by the government when proposing the ceiling. Instead, the ratio of the expenditure to potential GDP has been cited as a guiding principle for establishing the appropriate expenditure level.

## F. Legislative Status

The fiscal framework in Sweden is not anchored in legislation. Instead it is founded in a *political commitment* reinforced by strong expectation from outside observers. Formally, the government outlines for parliamentary approval the framework for the medium- and long-term sustainability of government finances in the budget documents each year. There are no obstacles to changing previous assessments or commitments, but more fundamental departures from established practice would most likely provoke a reaction from parliament and the public.

In line with this, the expenditure ceiling has the status of a parliamentary decision,<sup>66</sup> and approved ceilings can be changed by a new decision. The technical adjustments of existing ceilings that are routinely made to ensure that ceilings are not affected by changes in the

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<sup>65</sup> Up until 2007, the targeted general government net lending was 2.0 percent on average over the business cycle. With Eurostat's reclassification of the funded Premium Pension System from the public to the private sector, the target was changed to 1.0 percent. This change had a marginal impact on the long-term profile of government debt.

<sup>66</sup> Formally, there is a slight difference between the parliamentary decision on the ceiling for the upcoming year, and the ceilings for the second and third additional years. In practice, this is without consequence, and once approved by parliament the ceilings are perceived as equally binding, for all years.



structure of the general government finances do not require any special procedures. Despite this relative lack of formal obstacles, there has been only one instance in which the government proposed changes to existing expenditure ceilings with reference to the room for fiscal policy. The incoming government in 2006 proposed a reduction of the ceilings for 2007 and 2008 to reflect a reorientation of fiscal policy with lower expenditure and tax reductions.

As part of the reform of the budget process in Sweden in the mid-1990s, an organic budget law was introduced. This law does not explicitly require the government to propose an expenditure ceiling to parliament, but regulates matters that have an impact on how the ceiling is interpreted, such as budgeting and accounting principles, presentation of expenditure forecasts, and funding of investment expenditure. The organic budget law also establishes that *if* an expenditure ceiling has been decided upon, the government is expected to ensure compliance. More specifically, if there is an indication that the ceiling may be exceeded, the government has to initiate expenditure-reducing measures within its mandate or—if this is insufficient—propose budget amendments to parliament. Neither in the organic budget law nor in any other documents or statements by parliament is there any indication of what would happen if a ceiling was exceeded. Given the high profile of the ceiling, a violation would most likely come at a substantial political cost.

## VI. CONCLUSION

All three of the countries surveyed here have had positive experiences with expenditure ceilings. From a fiscal point of view, Finland, the Netherlands, and Sweden have all performed well since the introduction of their ceilings regimes. An unambiguous correlation between the introduction of expenditure ceilings and robust public finances is difficult to establish, particularly since economic growth has been relative strong and stable in recent times. The general impression in the respective countries seems to be that the expenditure ceilings model has contributed to maintaining stable finances, however.<sup>67</sup>

In all of the three countries, the introduction of an expenditure ceilings regime was preceded by severe fiscal difficulties. In the case of Sweden and Finland, the crisis was unprecedented in modern times, and created an awareness of the importance of stable and sustainable public finances. Interesting to note is that the expenditure ceilings were introduced *after* the consolidation had been completed, and were not part of the effort to bring down the expenditure ratio. The ceilings have been used to maintain stability, not to create it.

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<sup>67</sup> In Finland, see for example: Kinnunen (2006), Ministry of Finance (2006), Ministry of Finance (2007a), Ministry of Finance (2007b); for the Netherlands, see for example: Tijsseling et al. (2004), Ministry of Finance (2006), Ministry of Finance (2007), Bos (2007); for Sweden, see for example: SOU 2000:61, Hansson-Brusewitz and Lindh (2005), Ministry of Finance (2006), Ministry of Finance (2007).

The emergence of the ceilings from a fiscal crisis may also explain the firm political commitment to the fiscal framework. In none of the three countries are the ceilings regulated in legislation, and there are no predetermined sanctions for exceeding the ceiling.<sup>68</sup> The reliance solely on a political commitment does not in any way seem to have diminished the significance attached to, and the compliance with, the ceilings. In the political landscape in Finland and the Netherlands—with a tradition of coalition governments—the ceilings are seen as a part of the agreement between the parties forming government. A desire to maintain tranquility and stability appears to be sufficient incentive for compliance. In Sweden, the high profile of the expenditure ceiling implies that a violation would come at a significant political cost for the government.

The introduction of the ceilings regimes has not been seamless, and in all of the three countries there have been repeated evaluations, based on which adjustments have been made. In the Netherlands, a study group is appointed at the end of each government term to analyze and work out proposals for the construction of the expenditure ceiling for the upcoming term. In Finland, a thorough evaluation of the system with expenditure ceilings was conducted after the first government term. Several changes were made based on this report. In Sweden, the system with expenditure ceilings was evaluated by a government commission in 2001, and once again by an internal working group in the Ministry of Finance in 2007. The changes to the fiscal framework have been limited.

Regarding comprehensiveness, all three countries have come to the conclusion that interest expenditure should be excluded from the ceiling. In the case of the Netherlands, this type of expenditure was included until 2007, when a decision to reduce comprehensiveness was made. The potential problems caused by a variation of non-cyclical entitlements have not been seen as a sufficient reason to completely exclude this expenditure category by any of the three countries. In the case of Finland, the organization of a significant part of transfer payments in funds outside the budget excludes entitlements payments, but not the government contribution to the funds, from the ceiling. With respect to cyclical expenditure, the emerging message is less clear. In the Netherlands and Sweden, wide comprehensiveness has been considered important, and cyclically sensitive expenditure is included under the ceiling. In Finland, there has been an attempt to separate the cyclical component of government expenditure from the ceiling, while at the same time include structural changes in labour market policies. All countries allow some non-distortionary earmarked revenue to offset expenditure, *i.e.*, a net treatment under the ceiling. Finland has gone the furthest in excluding expenditure that—because of offsetting revenue—does not affect the government balance. All three countries have set up some special arrangements for investment expenditure. In Finland and the Netherlands, some investment expenditure is allowed outside

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<sup>68</sup> In the case of Sweden, the Budget Act requires the government to take action if there are indications that a ceiling will be exceeded. The Act does not require the use of a ceiling to restrict aggregate expenditure.

the ceiling. In Sweden, some investment has been financed through internal loans in the Debt Management Agency, rather than by appropriations.

The practice regarding inflation adjustment varies among the three countries. Finland and the Netherlands set their ceilings in real terms. Sweden sets nominal ceilings.

Fiscal sustainability is highlighted as an important objective for the expenditure ceilings in all three countries. It is therefore striking that no country explicitly presents a methodology for calculating the ceiling that links the level of ceiling-restricted expenditure to projected revenue and the targeted balance. There seems to be a reluctance to relinquish the authority to determine the aggregate level of expenditure by formalizing a calculation of the ceiling.

All three countries set their ceilings in a medium-term perspective. In Finland and the Netherlands, where the ceilings form part of the coalition agreement between the parties that make up the government, the ceilings are set for the full four-year term of the government. In Sweden, the ceiling is constructed as a three-year rolling ceiling, where an additional outer year is added every year. On several occasions, the government has refrained from proposing a ceiling for the additional third year. A plausible explanation for this reduction of the time horizon is that the uncertainties in the medium term were recognized, and that the government was hesitant to make a binding commitment to a maximum level of expenditure.

## SUMMARY TABLE

|                        | Comprehensiveness    |                           |                      |                               |   | Inflation adjustment  | Flexibility instruments                            | Time horizon                                    | Numerical definition | Status                                       |
|------------------------|----------------------|---------------------------|----------------------|-------------------------------|---|---|--|---|----------------------|--|
|                        | Interest expenditure | Non-cyclical entitlements | Cyclical expenditure | Earmarked revenue             | Investments   |   |  |   |                      |  |
| <b>Finland</b>         | Excluded             | Partly excluded           | Partly excluded      | EU funds, lottery revenue     | Rule for revenue from the sale of government property | Real ceiling converted with a government expenditure deflator | Possibility to carry over an ex post budget margin | Four-year fixed ceiling for the government term | Not presented        | Coalition agreement                          |
| <b>The Netherlands</b> | Excluded             | Included                  | Included             | Some non-tax revenue excluded | FES-fund  | Real ceiling converted with national income deflator          | Small contingency margin                           | Four-year fixed ceiling for the government term | Not presented        | Coalition agreement                          |
| <b>Sweden</b>          | Excluded             | Included                  | Included             | User fees                     | Internal loans  | Nominal ceiling   | Contingency margin                                 | Three-year rolling ceiling                      | Varies               | Political commitment, parliamentary decision |

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