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# Comment on Mats Persson: Swedish Government Debts and Deficits, 1970–1995

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This is an interesting paper; it covers a lot of ground and analyzes Swedish government finances from different angles, some of which rarely appear in the public debate. Although the paper is basically descriptive, it makes some attempts to explain the quite dramatic development of Swedish government finances during the last 25 years, basically by comparing the actual development with the predictions of recent theoretical models. The conclusions are rather vague and the reader is to some extent left to continue speculating on his own. In my comments, I focus on the first part of the paper covering factors behind the sharp increase in Swedish public debt.

One of the questions that is discussed at length is why the trends in the direction of increasing deficits seem to have been stronger in Sweden than in the rest of the OECD. One possible explanation is based on so-called strategic deficits. According to this hypothesis a Conservative government runs a large deficit, thereby tying the hands of its successor. The author rejects this hypothesis on two grounds. First, the deficits seem to have been largely unexpected and second, there were basically no substantial discretionary changes in the tax and transfer systems during the periods in question.

The argument that the deficit is not strategic because the government's forecasts consistently underestimate the deficit seems weak. Surely a government which is willing to run up large budget deficits to sabotage the position of its successor, i.e., the opposition, would be able to publish

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misleading forecasts. These forecasts could then influence those of other institutions in the private sector.

It may also be questioned whether the absence of discretionary changes in the tax and transfer system really is a sufficient reason to conclude that a deficit is not strategic. Refraining from taking measures needed to prevent deficits from growing does not seem to be very different from causing the deficit by discretionary changes in the tax and transfer systems. I share the conclusion that the Swedish budget deficits were not strategic, although it can hardly be based solely on this argument.

Admittedly, the runup of debts may not reflect a deliberate strategy, but I believe that these observations point to a more fruitful way of analyzing the emergence of deficits, namely as a result of inertia and inability of the political system to change the direction of economic policies as underlying economic structures and developments call for action.

An alternative explanation of budget deficits discussed in the paper is that the deficit is the difference between two stochastic processes – government revenue and government spending – and that the difference between two large numbers could easily be a large number itself. The argument is that since the covariance between spending and revenue is negative, the fiscal imbalances could, by an unfortunate realization of the underlying stochastic process, turn out to be very large.

Although I find this view a somewhat passive way of looking at budget deficits it is still, in it's simplicity, quite interesting. In particular, it focuses on the sensitivity of revenue and spending to exogenous chocks. An interesting question in this context is whether the tax reform of 1990-1991 changed the sensitivity of revenue and spending.[1] The previous tax system was undoubtedly highly distortionary. One of the intended results of the reform was a shift in the relative importance of government revenue from income taxes to indirect taxes, mainly the value-added tax. This may, however, have resulted in an increased variance of government revenue. In other words, although indirect taxes are less distortionary in that the tax base, i.e., basically private consumption, is less affected by the tax rate itself, it might well be that the tax base is more variable over the business cycle. This effect becomes more important if households are uncer-

[1] The 1990-1991 Tax Reform has been called the Tax Reform of the Century. Despite its name, numerous changes have been undertaken. Tax bases have been changed and some tax rates have been lowered further, only to be raised again. For a description of the Swedish tax system, see Mutén and Andersson (1996).

tain about future growth prospects and therefore possible future changes in the tax- and transfer systems. The finding in the paper that it is the revenue from indirect taxes that falls most sharply during the studied debt episodes points to relatively large fluctuations in the tax base for indirect taxes.

Hence, it is quite possible that a necessary reduction in tax-induced distortions has resulted in a larger variance of government revenues. This argument should not, of course, be interpreted as denying the necessity of the tax reform. It merely suggests that in a theoretical sense, a risk-averse government may decide not to reduce the distortions in the tax system in accordance with economic efficiency, but rather maintain some distortionary taxes in order to reduce the variance of government revenue. Such a behaviour would of course be unfortunate. The changes in tax revenues, and in government spending, can partly be expected to be temporary during the period households and firms adjust their behaviour to the new incentive structure prevailing after a tax reform. Once some of these adjustments have taken place, it seems reasonable to assume that the variance in revenues could decrease again.

The conclusion in the paper regarding budget deficits is not very clear. It is claimed that both of the debt episodes were driven mainly by the business cycle. The principal explanation for the government debt problem given in the paper seems to be that Sweden, for some reason, has been endowed with a certain set of political institutions conducive to a large public sector. This, in combination with an unfortunate macro-economic outcome, is claimed to be the major factor behind the development of Swedish government finances over the past 25 years.

I do not find this explanation very satisfactory. The sensitivity of the budget to the business cycle is likely to be higher, the larger the size of the public sector, but there is no reason why this effect should not be symmetric (except for interest payments on the debt). Does this mean that Sweden, with a little more luck, would have run huge surpluses in government finances during the last two decades?

The paper would undoubtedly have benefited from a more thorough analysis of why the Swedish economy, over a period of more than two decades, was only able to generate very limited surpluses in central government finances during a few years towards the end of the 1980s. In particular, I would have liked to see some further effort to identify the structural causes behind the development of government debt. Another aspect, not covered in the paper, is how the incentive structure for politicians influence budgetary developments. There are at least four classes of political models for fiscal deficits: the public choice approach of Buchanan; models of government weakness and decentralized government; models of strategic public debt choice; and political business cycle models.[2] One factor in the Swedish case may have been the short electoral cycle in Parliament, only three years. Furthermore, whether the government is single-party majority or a coalition government may have an impact on the likelihood for deficits to develop. The empirical support for political models of deficits seems to be growing.[3]

Let me mention some other factors which I believe contributed to the development of deficits and debts. With all due respect to my colleagues at the Ministry of Finance, I think it is virtually impossible, even in the short run, to forecast revenues and expenditures. The behavior of households and firms is very dynamic in this respect and they respond to incentives created by the tax and transfer systems.[4] The deregulation of factor markets and not least, financial markets, has made it very difficult for civil servants as well as politicians to control the outcome in what is after all some 70 percent of the economy (the share of the public sector of GDP). Politicians have to respond to these behavioral changes which result in changes in the tax system and in rules for transfer payments etc. This in turn makes households and firms even more eager to reap short-term benefits, resulting in poor overall economic performance. Adverse short-term economic developments during the transition period make politicians hesitant to undertake the necessary reductions on the expenditure side of the budget. The important aspects are therefore structural reforms and simple, long-lasting rules in order to achieve better control over government finances. With a large public sector it becomes increasingly difficult to avoid adverse incentive effects and the swings in the budget balance measured as a proportion of GDP tend to increase with the size of the public sector. With large deficits in the downturn, interest payments increase, making it very difficult to stabilize the debt to GDP ratio even with the best intentions among economists and politicians. To add governmental strategical aspects to such a complicated matter is not very realistic. The difficulties are severe enough anyway.

[2] See Buiter, Corsetti and Roubini (1993).

[3] See Roubini and Sachs (1989).

[4] For an analysis of the incentive effects of the Swedish tax and transfer system, see Andersson (1995).

In conclusion, I sympathize with the strategy in this paper. It discusses some of the theories behind budget deficits. The paper points to a need for further analysis in order to identify the structural causes behind the development of government debt in the last decades.

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