

Swedish Fiscal Policy

Meeting with IMF Country Mission

The Swedish Fiscal Policy Council

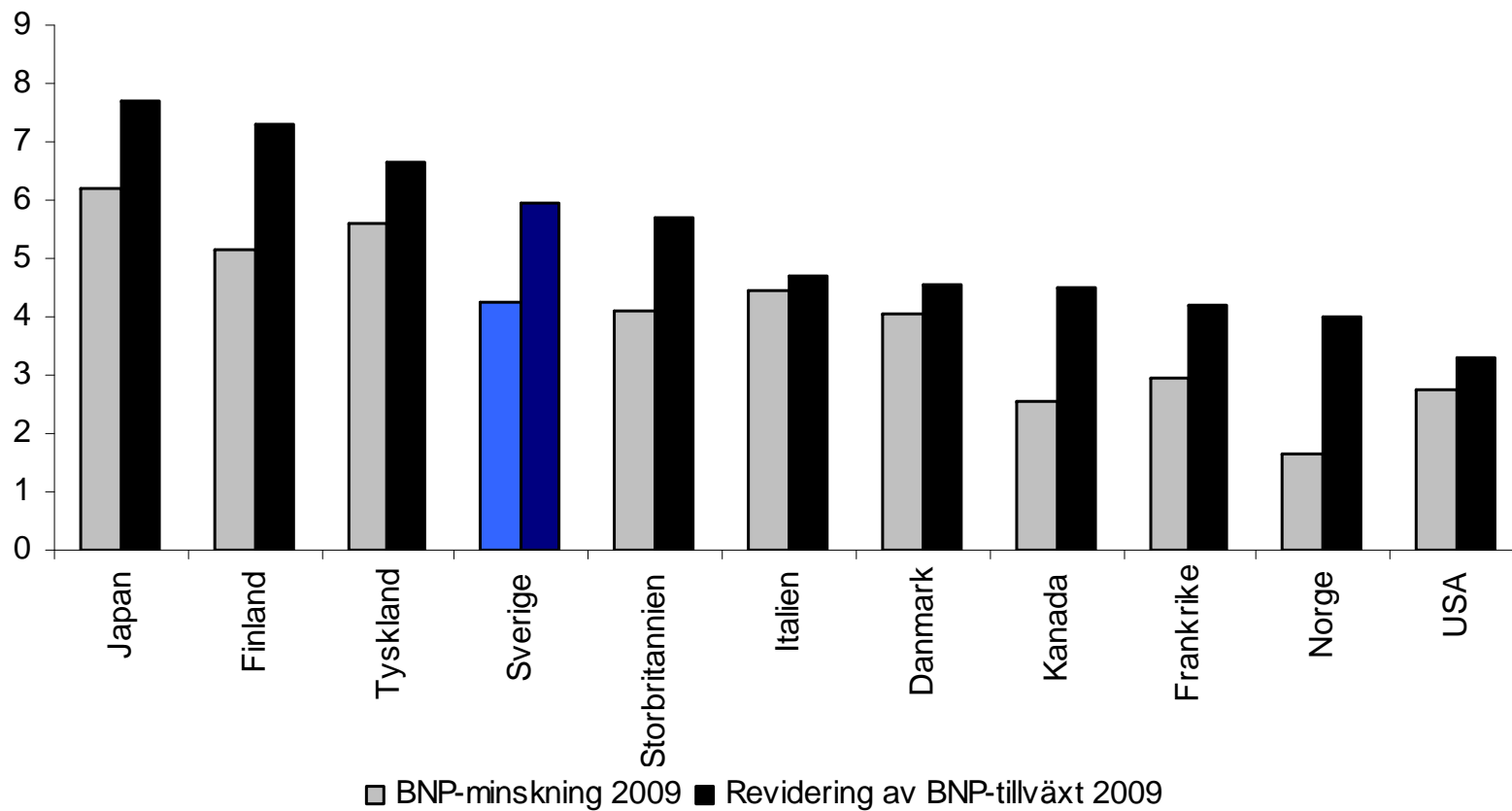
- Ex post evaluation of the government's fiscal policy and economic policy
 - fiscal sustainability
 - cyclical conditions
 - employment
- Annual report to the government
- Public hearing in the Finance Committee of the Swedish Parliament
- Independent government agency
- Eight members
 - six academic economists
 - two ex-politicians

Two main questions

1. How well has the government adjusted policy to the economic crisis?
2. How should the economic-policy framework be developed?

More proposals in this year's report than in last year's

GDP fall 2009, percent



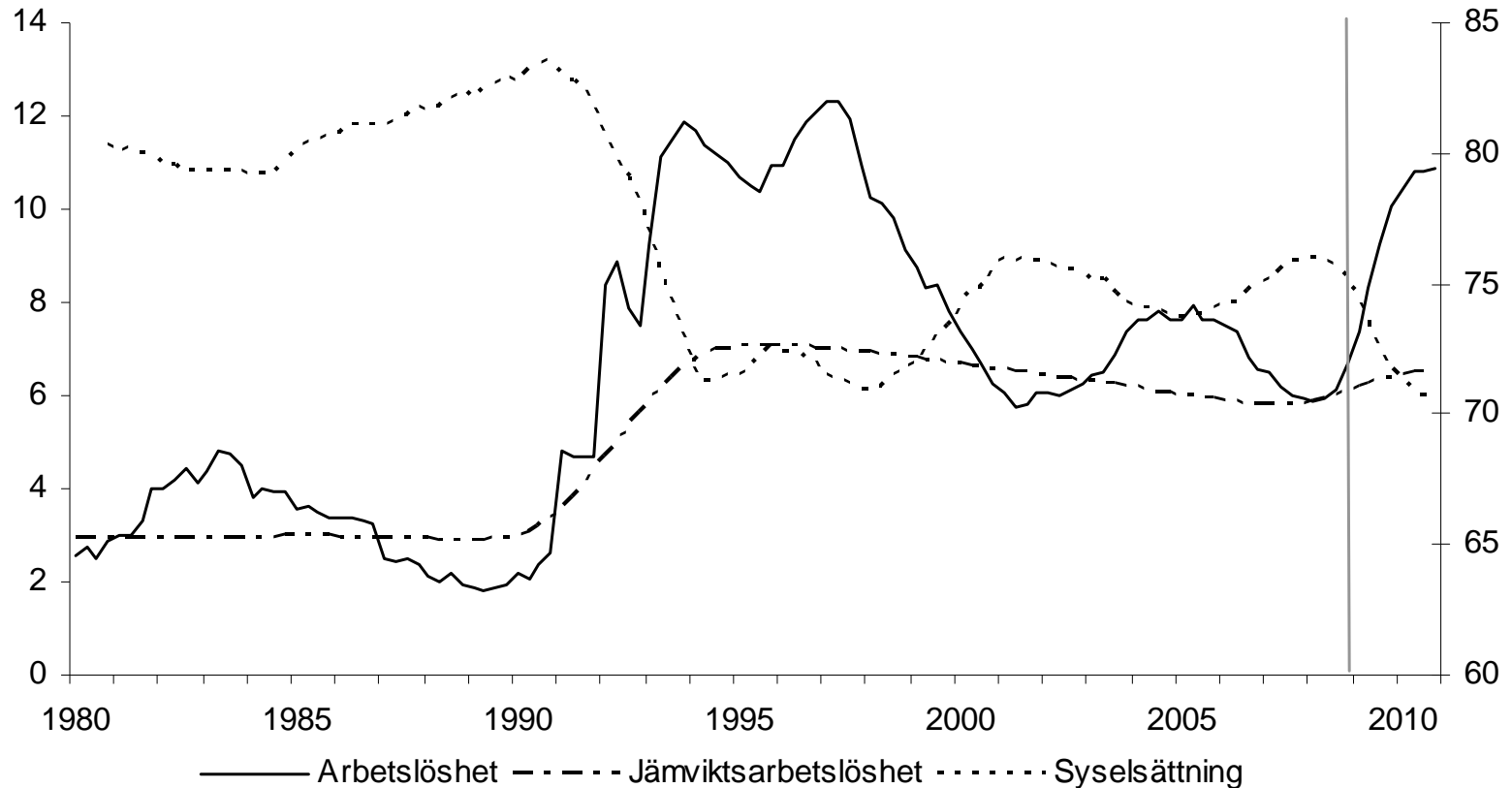
Selected indicators, spring 2009

| | FiD apr | FiD jan | KI mar | RB apr | OECD dec | IMF apr |
|-------------------------------|------------|------------|-----------|-----------|-------------|------------|
| GDP growth | | | | | | |
| 2003-2007 | 3,2 | | | | | |
| 2008 | -0,2 | 1 | -0,2 | -0,2 | 0,8 | -0,2 |
| 2009 | -4,2 | -0,8 | -3,9 | -4,5 | 0 | -4,3 |
| 2010 | 0,2 | 1,5 | 0,9 | 1,3 | 2,2 | 0,2 |
| Inflation | | | | | | |
| 2003-2007 | 1,5 | | | | | |
| 2008 | 0,9 | 0,9 | 3,4 | 0,9 | 3,5 | 2,1 |
| 2009 | 0 | -0,4 | -0,3 | 0,7 | 1,5 | -0,5 |
| 2010 | 0,7 | 1,3 | 0,8 | 1,9 | 1,1 | 0,5 |
| Unemployment | | | | | | |
| 2003-2007 | 7,1 | | | | | |
| 2008 | 6,2 | 6,2 | 6,1 | 6,2 | 6,1 | 6,2 |
| 2009 | 8,9 | 7,8 | 8,7 | 8,7 | 7 | 8,4 |
| 2010 | 11,1 | 8,6 | 10,7 | 10,7 | 7,7 | 9,6 |
| Government net lending | | | | | | |
| 2003-2007 | 1,4 | | | | | |
| 2008 | 2,5 | 2,3 | 2,5 | 2,3 | 2,8 | 2,5 |
| 2009 | -2,7 | -1,1 | -2,7 | -1,7 | 0,5 | -3 |
| 2010 | -3,8 | -1,1 | -4,6 | -2,6 | 0,4 | -3,8 |

Indicators for resource utilisation, spring 2009

| | FiD apr | FiD jan | KI mar | RB apr | OECD dec | IMF apr |
|--|------------|------------|-----------|-----------|-------------|------------|
| GDP-gap | | | | | | |
| 2003-2007 | 0,8 | 0,4 | -0,6 | 1,3 | 0 | 0,3 |
| 2008 | -1,8 | -1,5 | -2,4 | 2,1 | -1,2 | -0,6 |
| 2009 | -7,1 | -4,5 | -7,1 | -3,7 | -3,7 | -6,5 |
| 2010 | -8,7 | -5,3 | -7,8 | -4,3 | -3,9 | -7,7 |
| Labour market gap | | | | | | |
| 2003-2007 | | | -1,7 | -0,7 | | |
| 2008 | | | -0,1 | 2,7 | | |
| 2009 | | | -3,9 | 0,2 | | |
| 2010 | | | -6,5 | -1,6 | | |
| Equilibrium unemployment | | | | | | |
| 2003-2007 | | | 6 | | 7,3 | |
| 2008 | | | 6 | | 7 | |
| 2009 | | | 6,3 | | 6,8 | |
| 2010 | | | 6,5 | | 6,7 | |
| Cyclically adjusted net lending | | | | | | |
| 2003-2007 | 0,7 | 0,9 | 2,2 | | 1,4 | 0,9 |
| 2008 | 3,3 | 2,9 | 3,8 | | 3,2 | 1,8 |
| 2009 | 1,2 | 1,5 | 1,6 | | 2,2 | 0,2 |
| 2010 | 1 | 1,9 | 0,3 | | 2,2 | 0,2 |

Unemployment, equilibrium unemployment and employment, percent



Measures directed towards financial markets

- Higher deposit insurance
- Guarantees for medium-term bank borrowing
 - voluntary participation
- Financial crisis legislation
- Programme for capital injections
 - government equity capital
 - more generous rules for capital adequacy ratios
- Selective measures for Kaupthing bank and Carnegie
- Export credit guarantees and credit guarantees for the automotive industry
- Deferred payments of some taxes
- Loans to Latvia

The government's measures to handle the **financial** crisis have been adequate

- Good effects of the bank guarantee programme
 - critique against voluntary participation
 - but the important thing is the existence of a programme
- Legal framework to deal with insolvent banks should have been put in place earlier
- Establish a government agency to administer the support for the financial markets
 - unfortunate double role for the National Debt Office
 - both business transactions and administration of support programme

The government's fiscal policy

- 2009 Budget bill (september 2008)
 - reduction of structural surplus by around 1 percent of GDP
 - higher earned income tax credit
 - lower state income tax for middle income earners
 - reductions of payroll taxes
- Extra January bill
 - ROT-avdrag (stimulus of minor building activities)
 - labour market programmes
- Spring budget bill
 - labour market programmes
 - central government grants to local government 2010
- Additional reduction of structural surplus by 0,3 percent of GDP

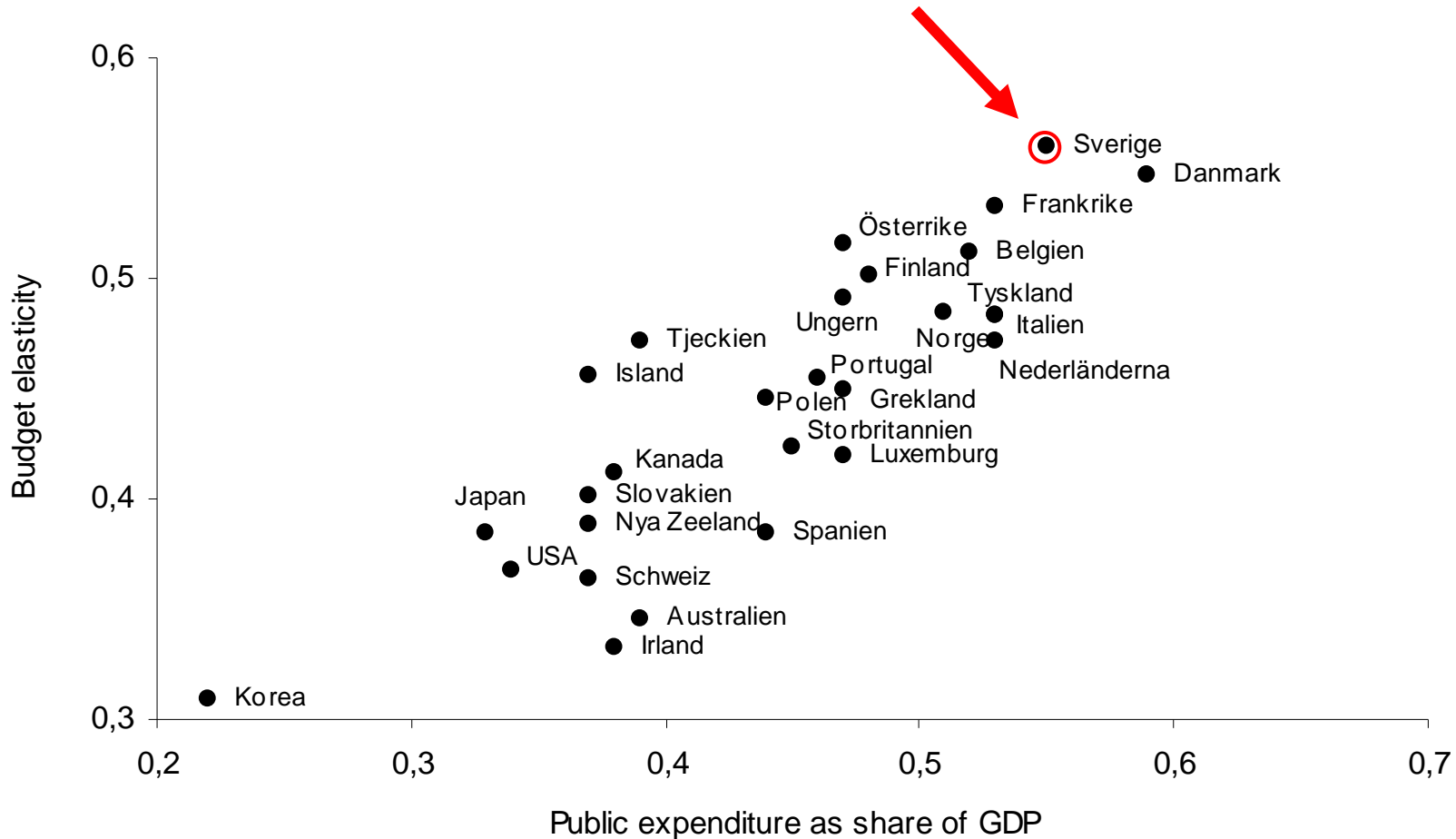
When should discretionary fiscal policy be used?

- Normally it should not be used
 - long decision lags and timing problems
 - risk of expansionary bias
- Requirements for use
 - large disturbances
 - value added over and above monetary policy

Need of more fiscal stimulus?

- Drastic revisions of the business cycle forecasts: from GDP rise of 1.3 percent to GDP fall of 4,2 percent
- Less generous unemployment insurance
- Tax cuts in the budget bill were not designed to stabilise the business cycle
- The automatic stabilisers have been weakened, but only marginally
- Risks for the sustainability of fiscal policy
- More difficult to stimulate the economy at later stages of the slump
- Households may save more
- Long-term interest rates may rise

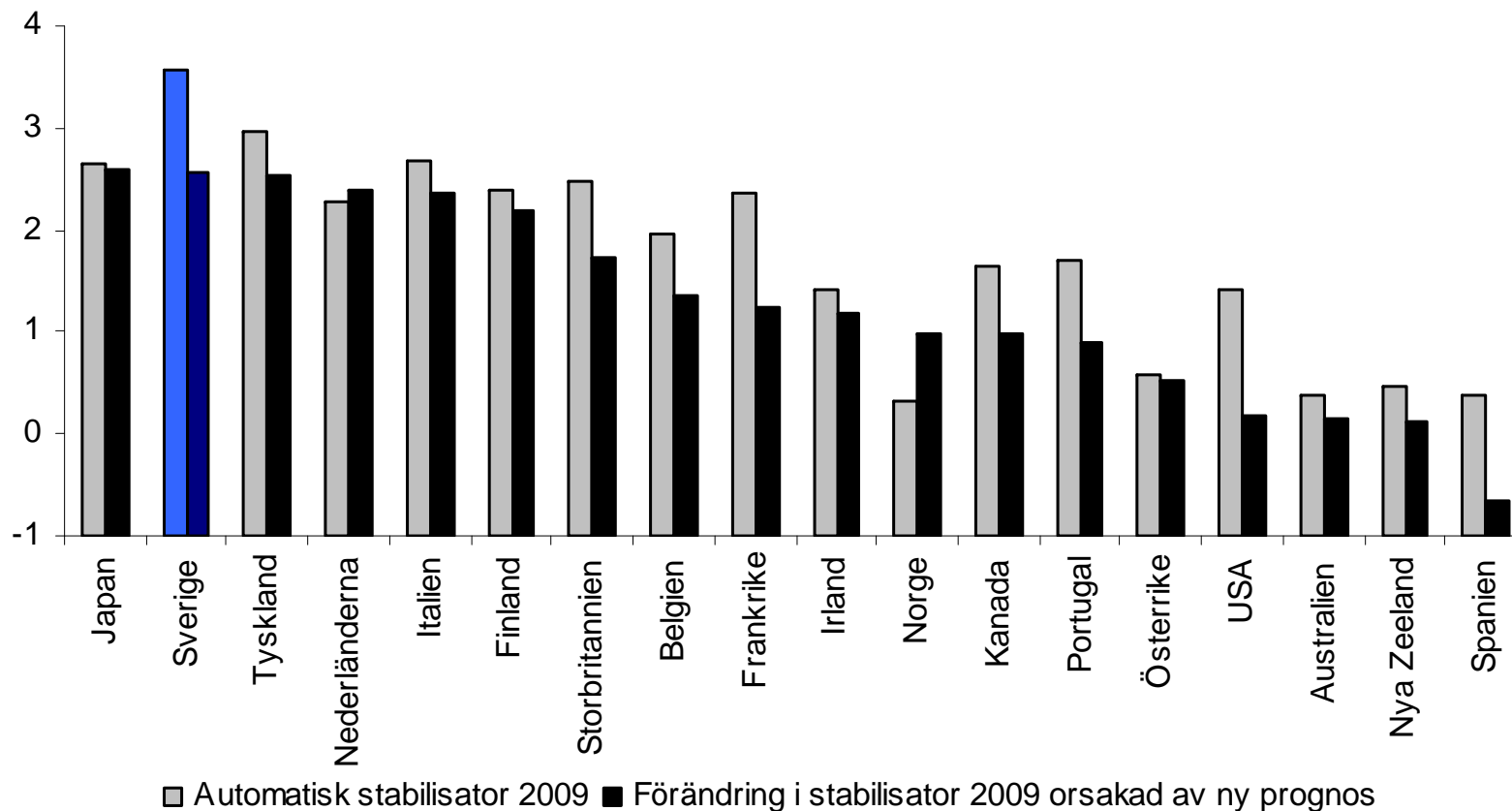
Budget elasticity and size of the public sector



Contributions to the budget elasticity

| | Inkomst- skatt | Sociala avgifter | Moms | Bolags- skatt | Arbetslöshets -försäkring | Budget- elasticitet |
|------|-------------------|---------------------|------|------------------|------------------------------|--------------------------------|
| 1998 | 18,0 | 12,8 | 12,0 | 3,5 | 12,1 | 58,4 |
| 1999 | 17,7 | 13,0 | 12,8 | 3,8 | 11,1 | 58,4 |
| 2000 | 17,2 | 13,1 | 12,7 | 4,9 | 11,3 | 59,2 |
| 2002 | 16,5 | 13,3 | 12,9 | 2,7 | 9,3 | 54,7 |
| 2003 | 16,9 | 12,6 | 13,0 | 2,9 | 9,0 | 54,4 |
| 2004 | 16,8 | 12,3 | 12,9 | 4,1 | 8,3 | 54,4 |
| 2005 | 16,9 | 12,2 | 13,1 | 5,2 | 8,0 | 55,4 |
| 2006 | 16,8 | 11,9 | 12,9 | 5,2 | 7,2 | 54,0 |
| 2007 | 17,0 | 12,0 | 13,0 | 5,0 | 7,3 | 54,3 |
| 2008 | 17,6 | 12,2 | 13,5 | 4,6 | 5,4 | 53,3 |
| 2009 | 17,4 | 12,2 | 13,3 | 4,9 | 5,4 | 53,2 |

The automatic stabilisers



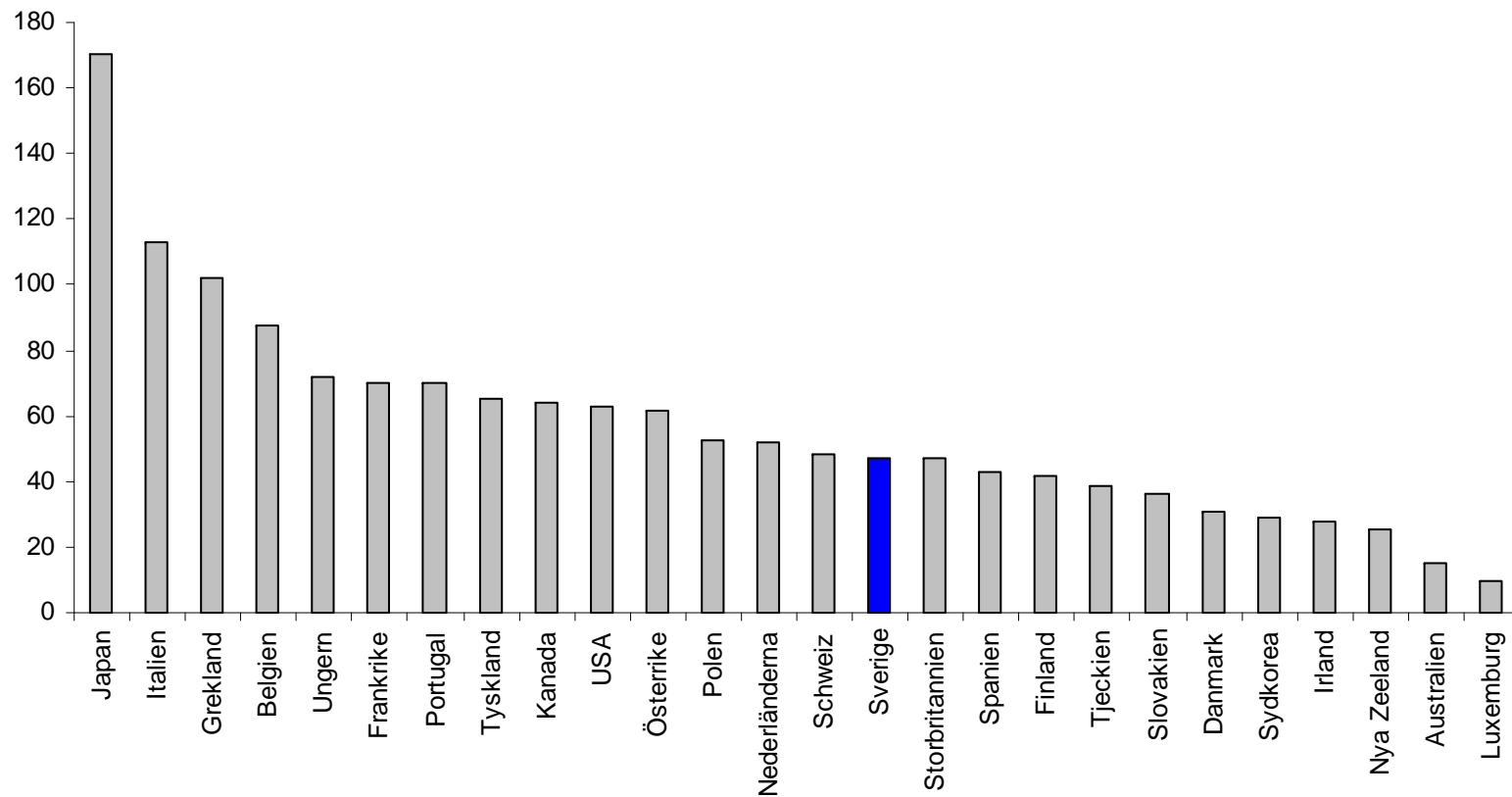
More stimulus desirable

- Up to 0,5 percent of GDP, up to 1 percent of GDP next year

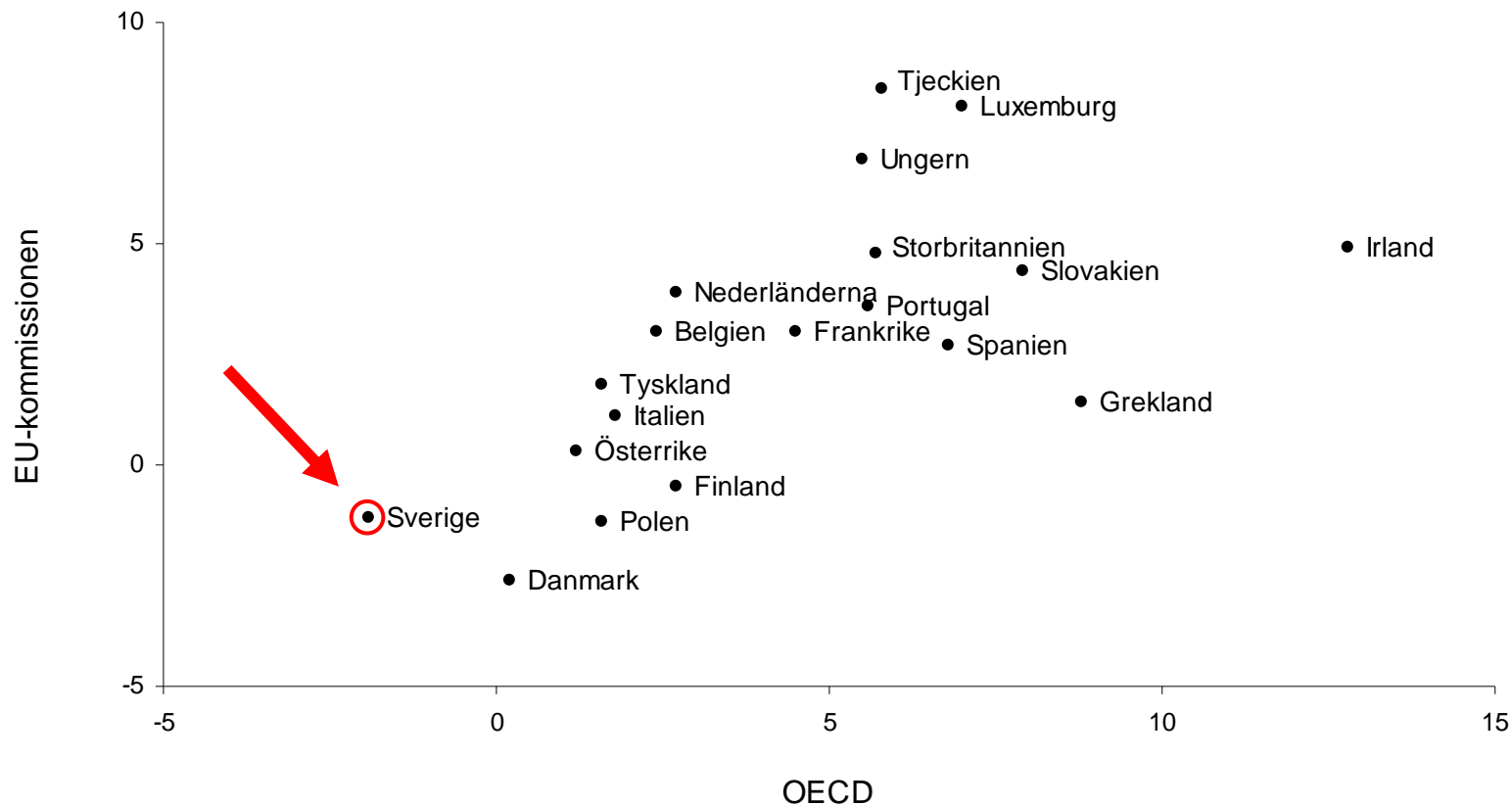
Reasons

- Still no structural deficit according to the government's calculations.
- Stronger public finances than in most other countries
- Stronger public finances than in the beginning of the economic crisis in the 1990s
- Stable fiscal policy framework
- Political consensus on strong public finances
- One-off costs of bank support have only a marginal effect on long-run sustainability

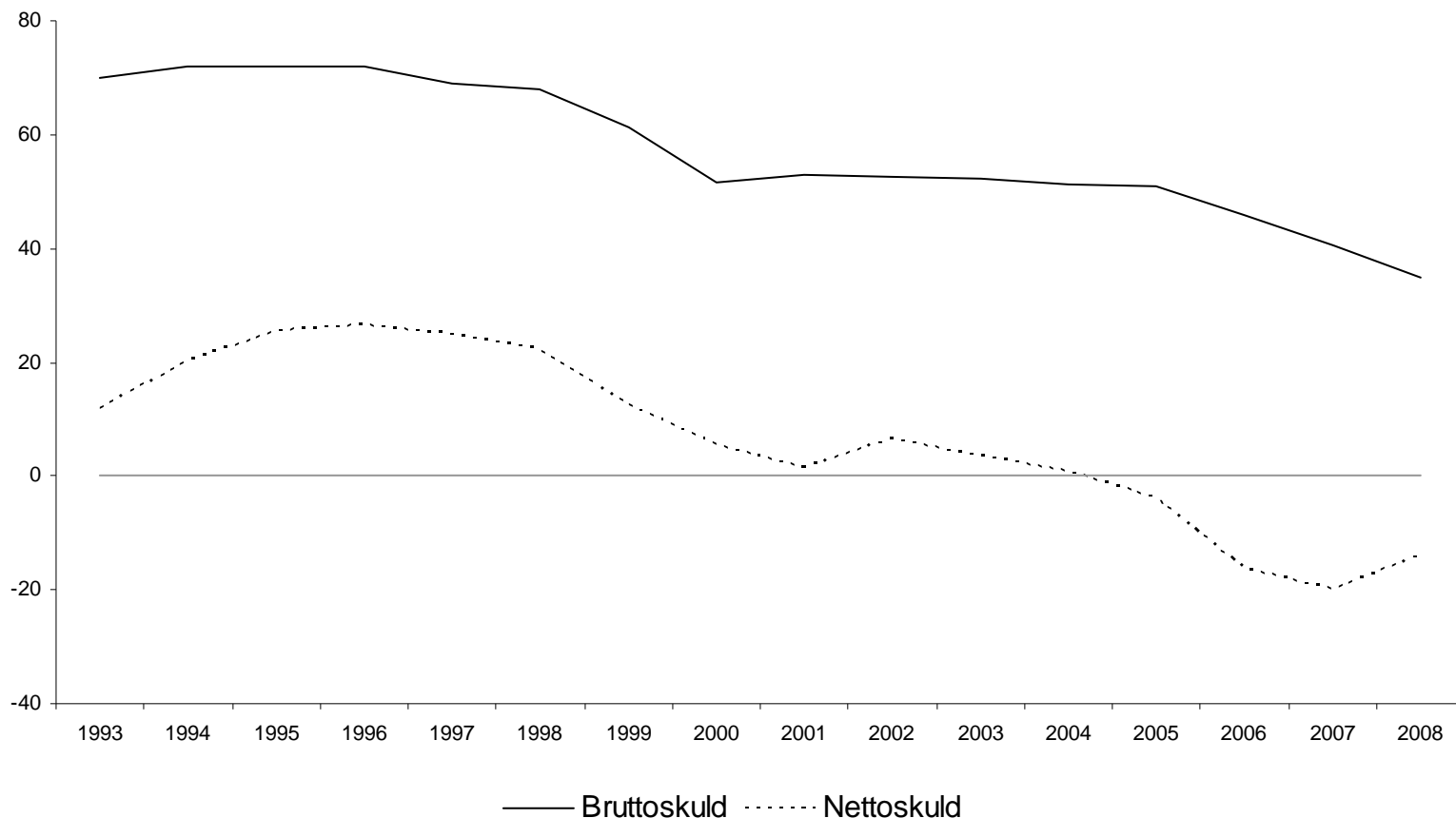
Gross public sector debt 2007 (percent of GDP)



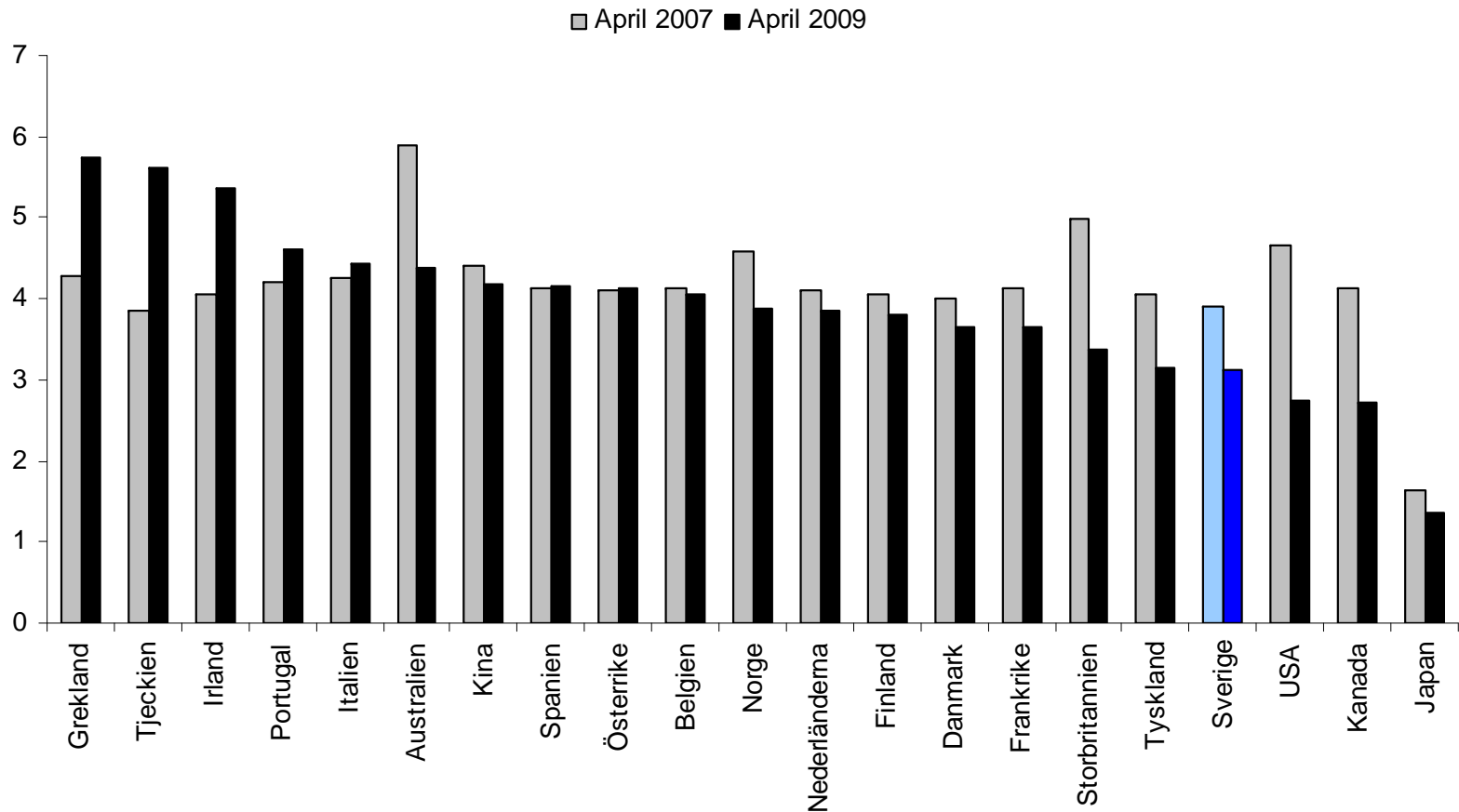
The sustainability of fiscal policy (the S2-indicator)



Public sector gross and net debt as percent of GDP



Interest rate on 10-year government bonds



Principles of discretionary fiscal policy

- Do not counteract automatic stabilisers
- Try to reduce uncertainty
- Temporary measures or "structurally correct" measures
- General, rather than specific, measures
- Cost-effective measures
 - higher multipliers on expenditure side?
 - targeted measures on (low-income) groups with high MPC

Possible additional measures

- Higher *temporary* central government grants to local governments
 - high multiplier for government consumption
 - only redistribution of savings from central to local government if money is not spent
- Subsidies for renovation of municipal housing stock
- Avoid that pensioners' incomes fall
 - temporary tax rebate?
- temporary tax rebate to low-income households in general?
- Increase study grants permanently
- Temporary increase in unemployment benefits

The government expenditure ceiling should not stand in the way

- Expenditure ceiling for central government three years ahead
- The purpose of the ceiling is to prevent that high tax revenues in good times lead to excessive spending
- Deviations should be possible under *exceptional* circumstances: *escape clause*
- The government has already manipulated the expenditure ceiling
 - central government grants for 2010 paid out in 2009
- Transparent escape clause is preferable

Balanced budgets for local governments

- Procyclical behaviour of local governments amplify cyclical fluctuations
- Central government grants should compensate for swings in the aggregate tax base of local governments

The Swedish business cycle 1995-2008

| Variabel, x | Genomsnitt relativt BNP ^a | Volatilitet (%) ^b | Korrelation med Δy_t | | | Cyklikalitet |
|----------------------|---|---------------------------------|------------------------------|--------------|------------------|------------------------------|
| | | | Δx_{t-4} | Δx_t | Δx_{t+4} | |
| BNP | 1,00 | 1,88 | -0,03 | 1,00 | -0,03 | procyklisk |
| Konsumtion | 0,75 | 1,26 | 0,02 | 0,68 | -0,09 | procyklisk |
| offentlig | 0,26 | 1,83 | 0,15 | 0,16 | -0,32 | - |
| statlig | 0,08 | 3,54 | -0,00 | -0,11 | -0,24 | kontracyklisk |
| kommunal | 0,18 | 2,18 | 0,18 | 0,28 | -0,23 | - |
| Investeringar | 0,17 | 4,69 | -0,03 | 0,55 | 0,29 | procyklisk |
| offentliga | 0,03 | 7,36 | 0,05 | 0,08 | -0,01 | acyklisk |
| statliga | 0,01 | 11,44 | 0,09 | 0,15 | -0,16 | - |
| kommunala | 0,01 | 8,03 | -0,03 | -0,08 | 0,22 | - |
| Anställda | 0,66 | 1,29 | -0,28 | 0,29 | 0,59 | procyklisk, eftersläpande |
| offentligt | 0,23 | - | 0,17 | 0,21 | 0,17 | procyklisk |
| statligt | 0,04 | - | -0,01 | 0,05 | -0,07 | acyklisk |
| kommunalt | 0,19 | - | 0,20 | 0,23 | 0,20 | procyklisk |

More generous unemployment insurance in slumps

- Earlier benefit reductions will reduce unemployment in the long run
 - stronger incentives for job search
 - stronger incentives for wage moderation
- But these factors are less important in slumps
- Generosity of unemployment insurance should vary with the cycle
 - such systems exist in the US and Canada
- With such variations, given average unemployment is consistent with higher benefits on average
 - average distortions are reduced
- Initial steps:
 - extend the period with benefits of 80 percent
 - increase both minimum and maximum benefits (floor and ceiling)
- Need for political consensus

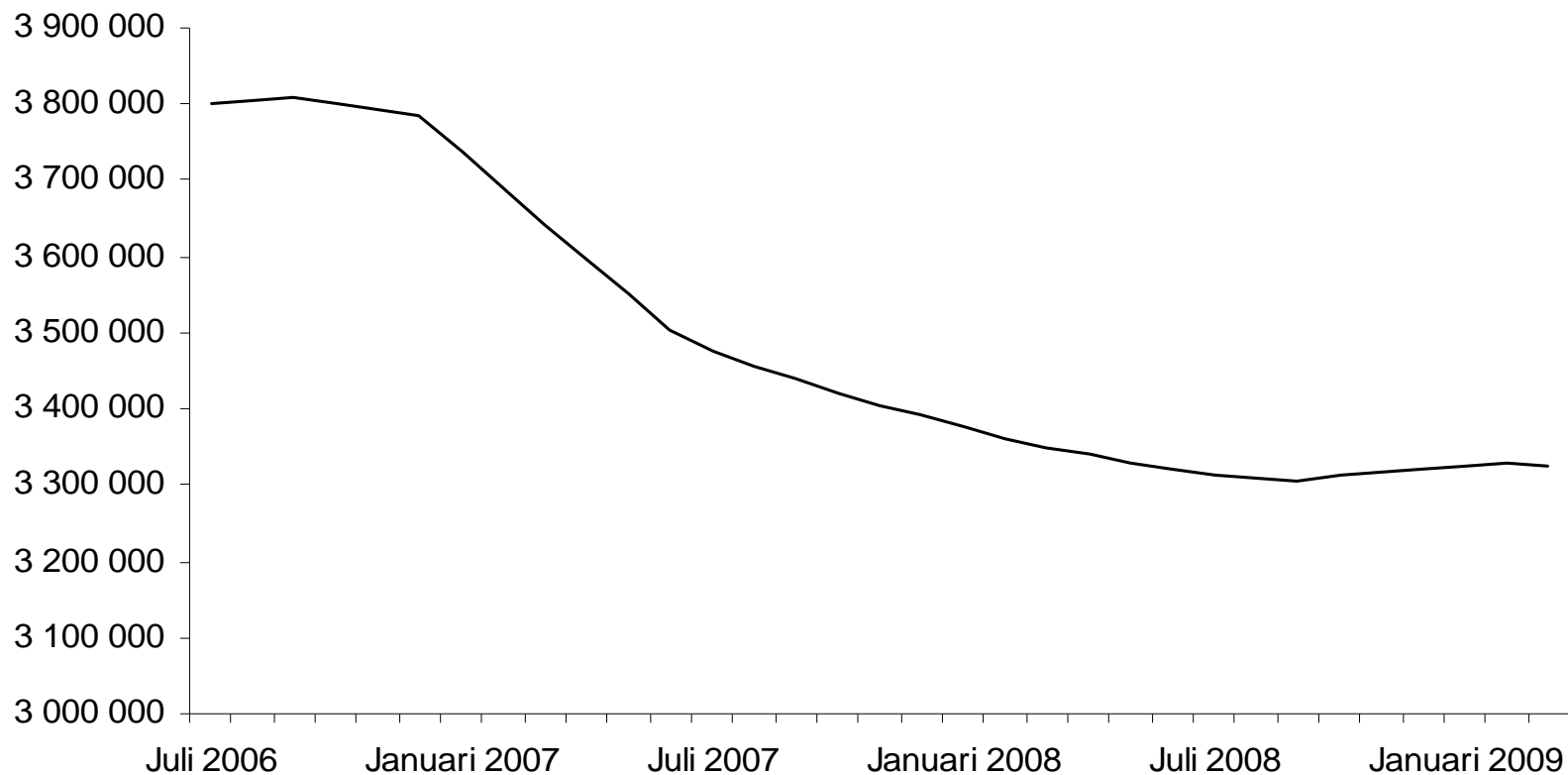
Financing of unemployment benefits

- Union-affiliated unemployment insurance funds
- Employee contributions have been differentiated and raised – 1/3 of benefit costs
- Large fall in membership of funds
 - higher relative price of unemployment insurance is not offset by higher income
- Employee contributions rise when unemployment rises
- "Automatic stabiliser"

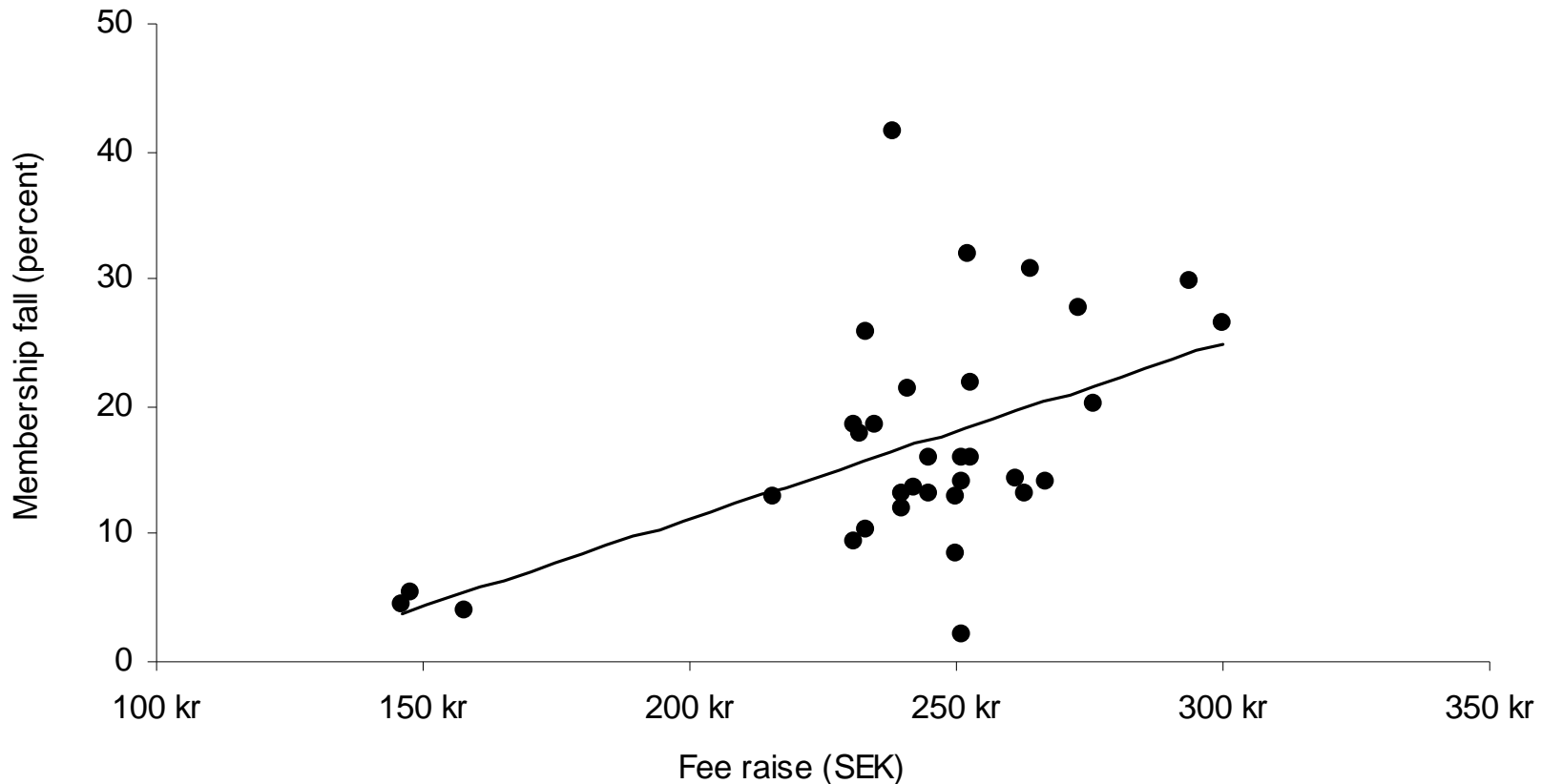
Possible solutions

1. Link contributions to relative unemployment, but not to average unemployment!
2. Mandatory government unemployment insurance

Total unemployment fund membership



Rise in contributions and membership fall (percent) in the different unemployment funds



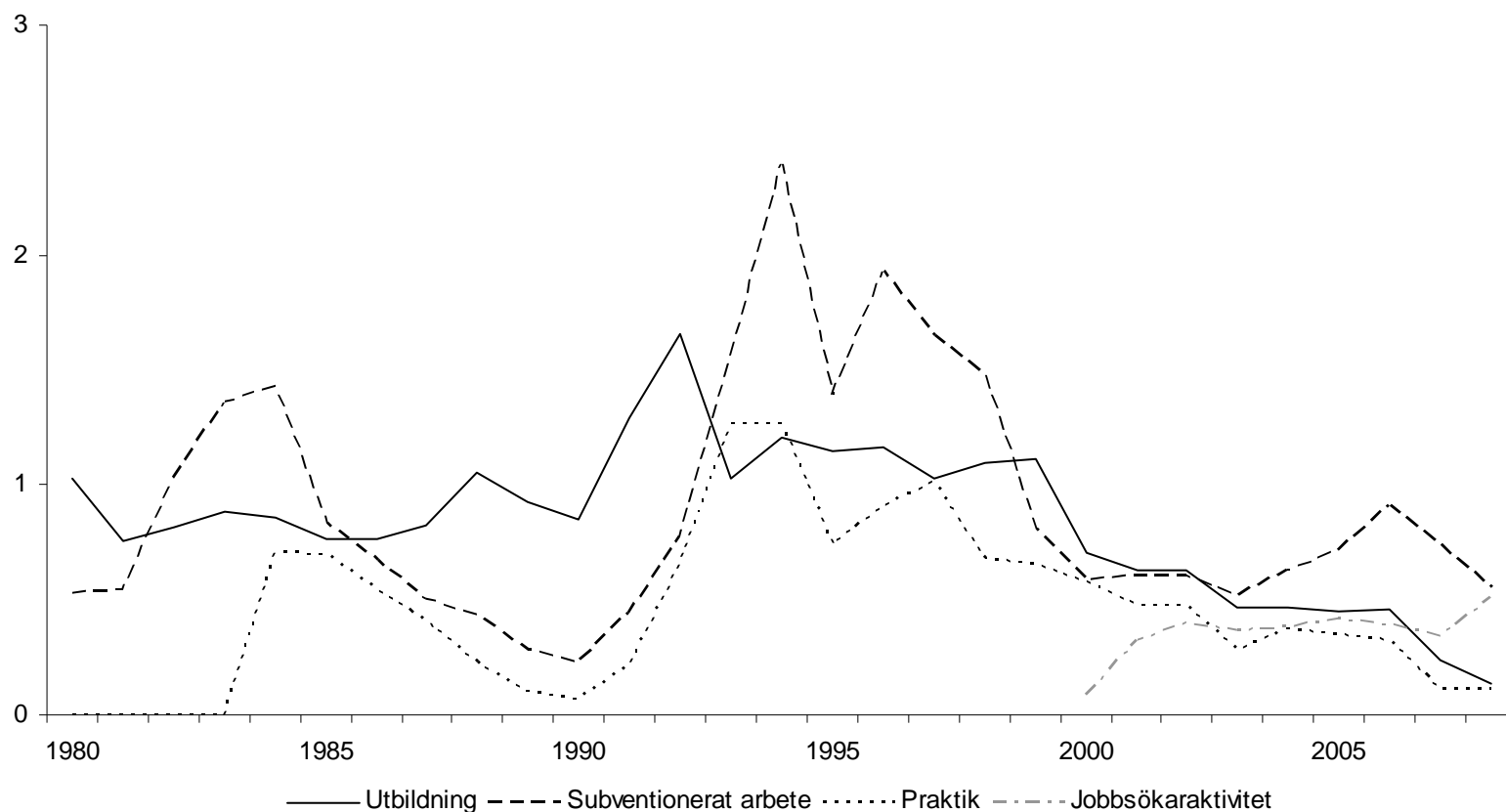
Strategies for active labour market policy

- The government's initial strategy: reduce persistent high unemployment in the boom
- Currently: handle a large *inflow* into unemployment and prevent long-term unemployment.
- Good with more measures directed towards the short-term unemployed
- Good to double the subsidy to start-up jobs for long-term unemployed

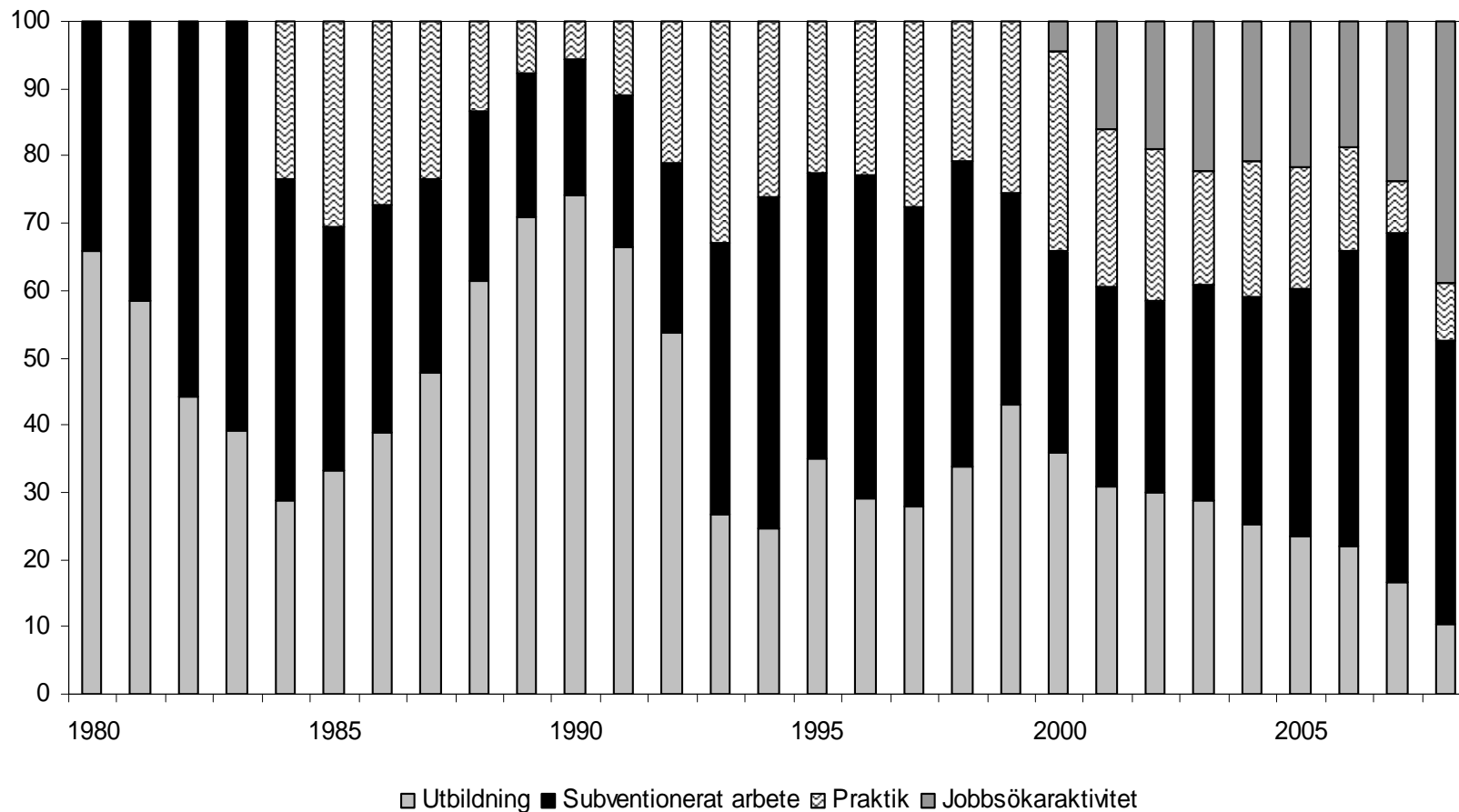
Critique of the labour market policy

- Focus on job search activities: questionable what it can achieve in a deep recession
- Volumes in labour market training are too low
 - overexpansion in the 1990s when used to requalify participants for unemployment insurance
 - but favourable evaluations for recent years
- Support for education within firms if collective agreements of working time and pay reductions concluded
 - structural problems or cyclical problems
 - such agreements can serve as signal of long-run viability

Participants in different programmes, percent of the labour force



Composition of programmes



Activities within the job and development guarantee, percent of participants in different activities at different periods in an unemployment spell

| Antal kalenderdagar | 1-104 | 105-209 | 210-419 | 420- |
|--------------------------------------|---------------|---------------|---------------|--------------|
| Arbetsträning | 4 | 8,5 | 13,7 | 17,2 |
| Projekt | 0,7 | 1,1 | 0,8 | 0,6 |
| Kartläggning | 25 | 14,6 | 11,3 | 6,9 |
| Förstärkt arbetsträning | 2,7 | 5,8 | 11,8 | 13,8 |
| Arbetslivsinriktad rehabilitering | 0,8 | 1,4 | 3,1 | 3,6 |
| Arbetspraktik | 7,3 | 13,9 | 18,3 | 18,4 |
| Start av näringsverksamhet | 0,5 | 1,5 | 2,2 | 2,4 |
| Jobsökaktivitet med coachning | 69,3 | 78 | 76,6 | 79,2 |
| Utbildning | 2,2 | 4,9 | 8,6 | 7,5 |
| Förberedande insatser | 2,1 | 3,3 | 4,5 | 4,7 |
| Fördjupad kartläggning/vägledning | 4,8 | 4,5 | 7,3 | 9,2 |
| Praktisk kompetensutveckling | 0 | 0 | 0 | 0 |
| Ingen registrerad aktivitet | 24,1 | 21,8 | 10,2 | 3,6 |
| Antal individer | 22 878 | 14 273 | 12 879 | 6 747 |

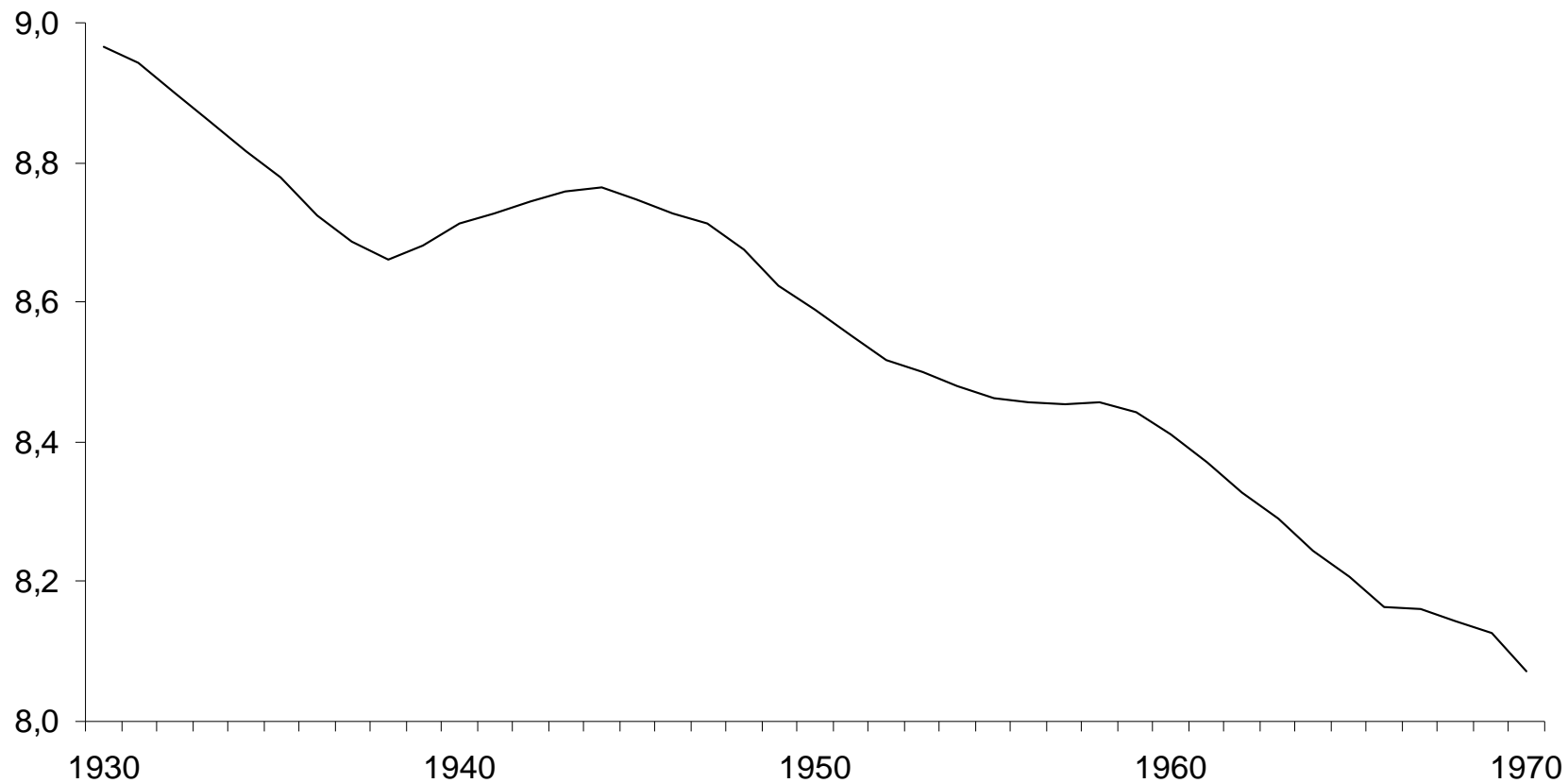
The fiscal policy framework and the surplus target

- Unclear interpretation of the surplus target: surplus of one percent of GDP over the cycle
 - *five* different indicators
- Need to motivate the surplus target
- *Pre-funding* or *longer working-life* to handle the fiscal consequences of an aging population
 - rise in longevity or fall in fertility
 - if rise in longevity redistribution of welfare to later generations (who gain already by living longer) through pre-funding
- Surplus and employment targets are mutually dependent
- The fiscal and employment frameworks should be integrated
- Interdependent decisions on fiscal and employment targets

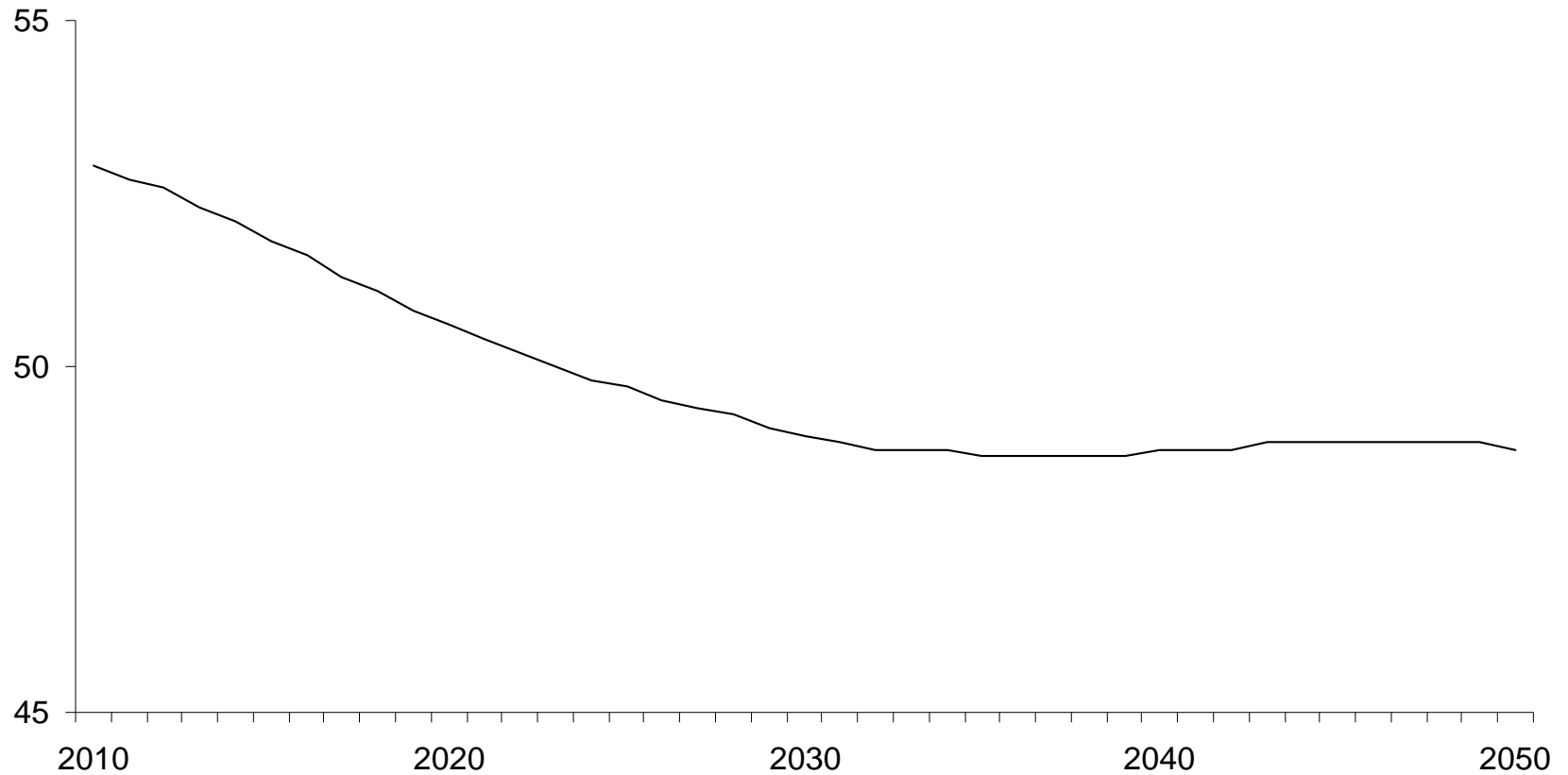
Budget surplus indicators

| | Budgetpropositionen för 2008 | | | | Budgetpropositionen för 2009 | | | | Vårpropositionen 2009 | | | |
|---|------------------------------|------|------|------|------------------------------|------|------|------|-----------------------|------|------|------|
| | 2007 | 2008 | 2009 | 2010 | 2008 | 2009 | 2010 | 2011 | 2009 | 2010 | 2011 | 2012 |
| Net lending | 2,9 | 2,8 | 3,1 | 3,6 | 2,8 | 1,1 | 1,6 | 1,5 | -2,7 | -3,8 | -3,1 | -2 |
| Average historical net lending | 1,3 | 1,5 | 1,7 | 1,8 | 1,5 | 1,5 | 1,5 | 1,6 | 1,1 | 0,7 | 0,4 | 0,2 |
| Average current net lending | 2,3 | | | | 2,1 | | | | -0,5 | | | |
| Structural net lending | 2,2 | 2 | 2,8 | 3,6 | 2,8 | 1,9 | 2,2 | 2,7 | 1,2 | 1 | 1,2 | 1,4 |
| Average historical structural net lending | | | | | | | | | 1,5 | 1,5 | 1,5 | 1,5 |
| Average current structural net lending | | | | | | | | | 1,7 | | | |

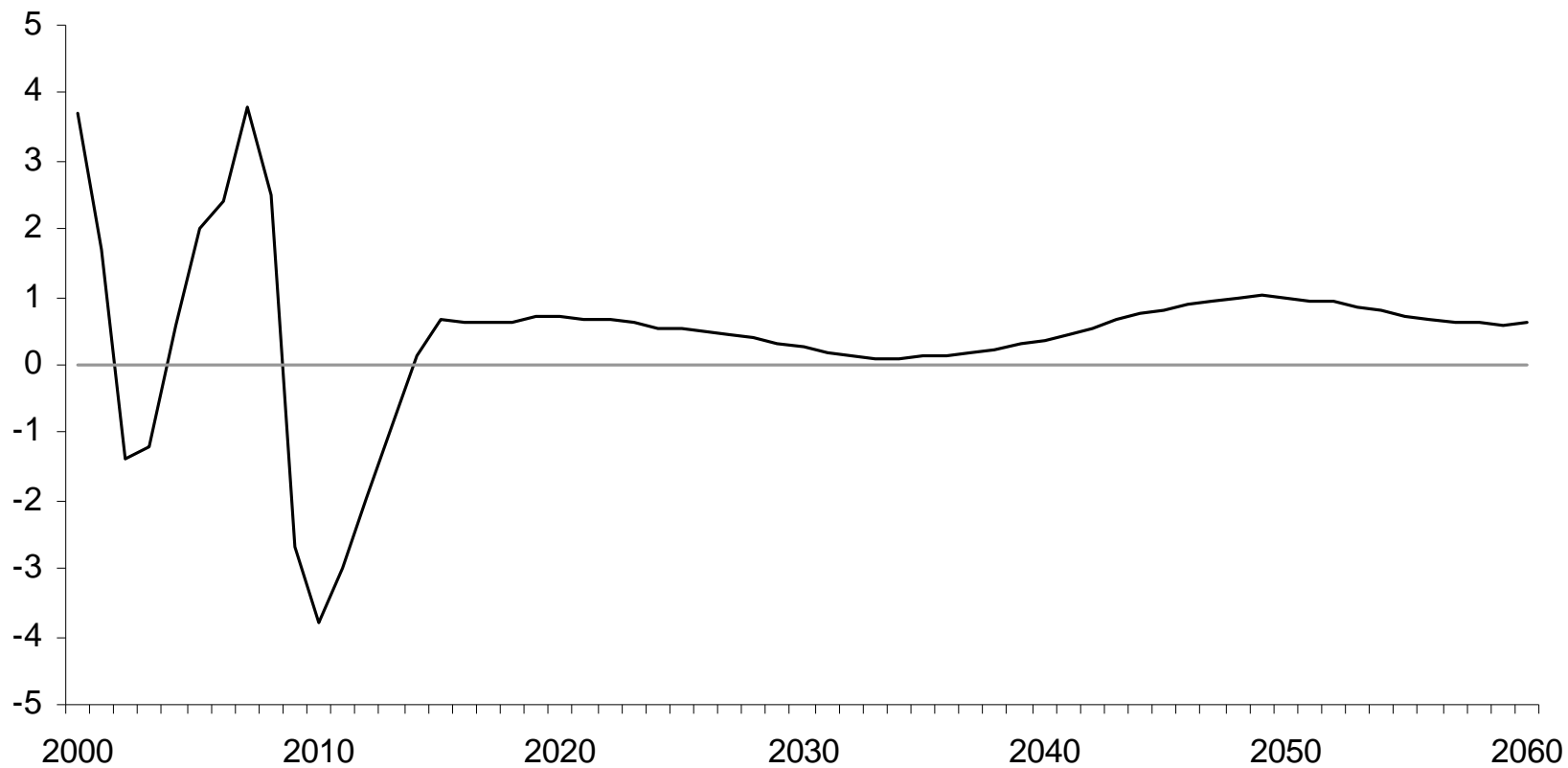
Fraction of life devoted to market work, percent



Labour force participation, percent of population



General government net lending, percent of GDP



Definitions

- **Intertemporal budget constraint:** Current financial net wealth must at least equal net present value of future primary deficits
- **S2-indicator:** Permanent budget improvement in percent of GDP necessary to meet intertemporal budget constraint
- **Intertemporal net financial wealth:** Current financial net wealth plus net present value of future primary deficits
- Positive S2-indicator corresponds to negative intertemporal financial net wealth

The S2-indicator and intertemporal financial net wealth, percent of GDP

| | S2 | Intertemporal finansiell nettoförmögenhet |
|---------------------|------|--|
| Basscenario | 0,5 | -52,5 |
| Högre utträdesålder | -0,8 | 84,0 |
| Högre vårdkostnader | 8,2 | -861,0 |

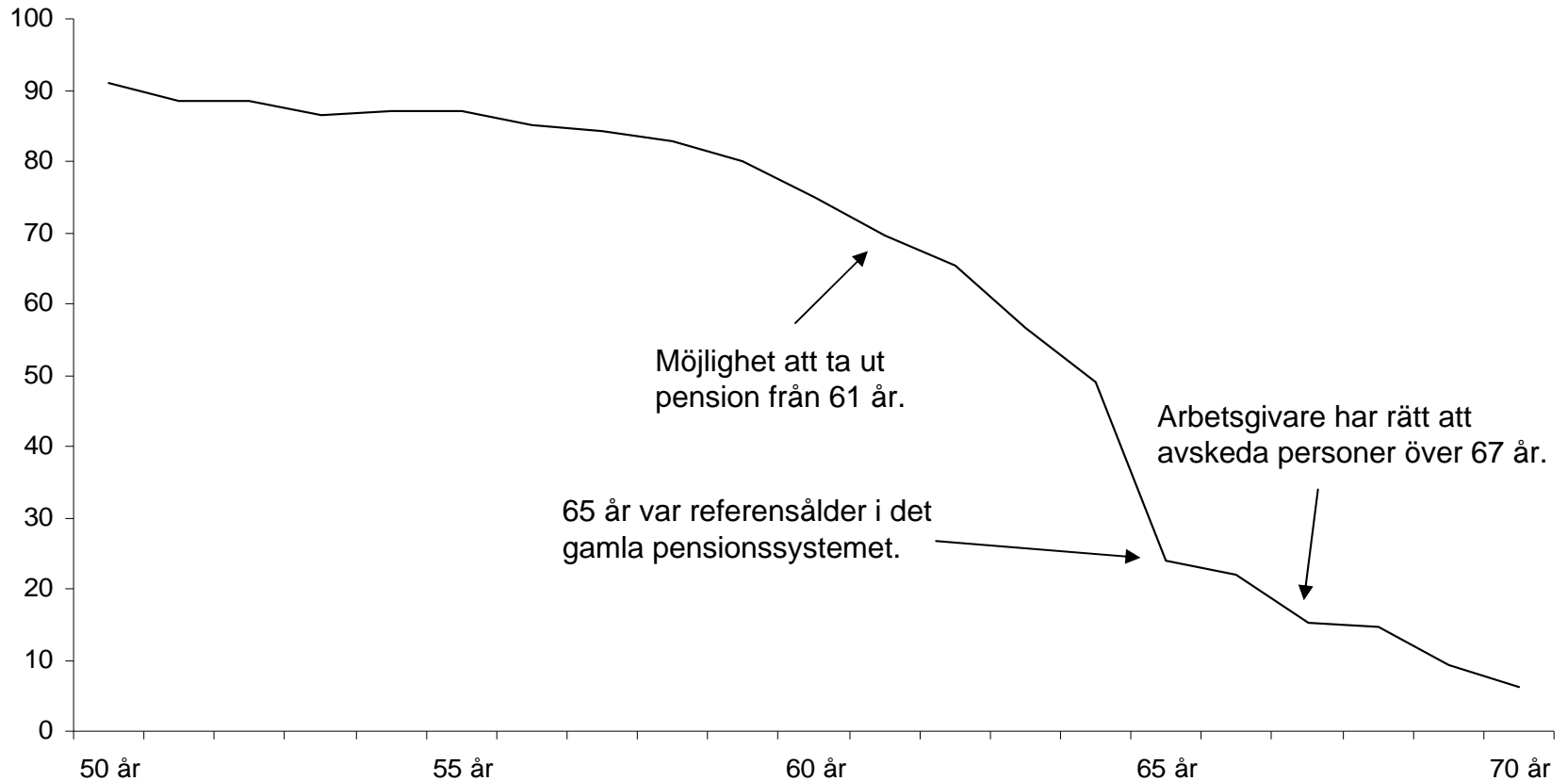
Automatic indexation of retirement age to life expectancy?

- Danish model
- But Sweden has no *formal* retirement age
 - the lowest age of retirement (61 years)
 - the age at which social insurance benefits are lost (65 years)
 - compulsory retirement age (67 years)
- Can the surplus target be revised downwards?

Estimated age of retirement with indexation to life expectancy

| | Förväntad återstående livslängd vid 65 års ålder | Pensionsålder vid samma förväntade antal år med pension som under 1970-talet vid 65 års ålder | Pensionsålder vid samma förväntade kvot mellan pensionsålder och livslängd som under 1970-talet vid 65 års ålder |
|-----------|--|---|--|
| 1971-1980 | 15,8 | 65,0 | 65,0 |
| 1981-1985 | 16,6 | 65,7 | 65,6 |
| 1986-1990 | 17,1 | 66,2 | 66,0 |
| 1991-1995 | 17,7 | 66,8 | 66,4 |
| 1996-2000 | 18,2 | 67,4 | 66,9 |
| 2001-2005 | 18,7 | 67,9 | 67,3 |
| 2006 | 19,0 | 68,3 | 67,7 |
| 2007 | 19,2 | 68,4 | 67,7 |
| 2008 | 19,3 | 68,5 | 67,8 |
| 2009 | 19,4 | 68,5 | 67,8 |
| 2010 | 19,5 | 68,6 | 67,9 |
| 2015 | 20,0 | 69,1 | 68,3 |
| 2020 | 20,4 | 69,5 | 68,6 |

Labour force participation at older ages 2008, percent



An integrated fiscal and employment framework

- Calculate S2-indicators for different assumptions on future working time (hours worked per person in the population) over the life cycle under the most probable assumptions
- Recalculate S2-indicators to allow for desired safety margins
- Choose strategy combination: S2-indicator and associated development of future working time over the life cycle
- Translate S2-indicator into *intermediary* budget target for given time period (ten years?)
- Specify means to achieve desired working time over the life cycle
 - indexation of retirement age to longevity?
- Continuous evaluation of whether budget and employment targets are achieved
- Plans for future fiscal and employment policy in case of large deviations from targets
- Repeat the procedure at the end of the time period for which targets were set (ten years?)
 - automatic considerations of earlier deviations

Impact of report

- Input into the political debate
- The government does not like the criticism, the political opposition likes part of it
- More politicised reactions this year than last year
 - EU elections and parliamentary elections next year
- A lot of media coverage
- Will the council remain after the next election?
 - the liberal-conservative parties cannot abolish it?
 - the current opposition?
- The council has been more activist than the government
 - instruction: long-run sustainability and cyclical considerations
 - credible fiscal framework should give room for manoeuvre