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SWEDISH FISCAL POLICY COUNCIL

Swedish Fiscal Policy

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Principal Conclusions and Summary

Principal Conclusions of the Report

The primary purpose of this report is to evaluate the current Government's fiscal and employment policies. The principal conclusions are the following:

- If the fiscal surplus target is to maintain its legitimacy, it should be better justified in relation to the fundamental objectives of income distribution between generations and social efficiency. This requires the Ministry of Finance to develop systematic generational analyses.

- The surplus target will gradually need to be revised downward as the demographic burden grows. However, uncertainty about the long-term sustainability of general government finances will warrant a surplus greater than one percent of GDP for the next few years.

- The possibility of introducing a so-called *golden rule* should be examined. With such a rule, the surplus target would apply to the *total saving* of the general government sector, including net investment, rather than just its net lending, as is the case today.

- Currently the budget and spring financing bills do not include any accounting for the development of the *total net wealth* (including the capital stock) of the general government sector. The bills thus convey an incomplete picture of the financial position of the general government sector. Such an accounting should be provided without delay.

- The Government's employment policy reforms, chiefly the reduction in unemployment compensation and the introduction of an earned income tax credit, can be expected to have significant positive effects on employment in the long run. The rise in employment over the past two years, however, is due mainly to a cyclical upswing.

- The Government has implemented a number of selective tax cuts directed at particular groups, such as young people, or particular sectors. While benefiting these groups, the tax cuts are unfavourable to others. Moreover, the measures make the tax system harder to understand, impairing social efficiency. Further selective tax reductions would probably have negative net effects on social efficiency.

- The reforms in the financing of the unemployment insurance system are inefficiently designed and have also reduced participation in the system. These effects are due to poor co-ordination between different parts of the system. The reform process will leave many wage earners without adequate unemployment insurance in the next economic downturn.

- The changes in the sickness insurance system strengthen the incentives for work but probably do not offer employers sufficient inducement to fulfil their responsibility for helping sick-listed persons return to the labour market.

- The reform of real estate taxation favours housing investment over business investment, causing overall efficiency losses for the economy. Since the reform also increases disparities in income, income distribution considerations will leave less scope for lowering other taxes that cause greater economic distortions, such as the tax on higher incomes.

- The lack of studies underpinning the real estate tax reform stands in stark contrast to the Government's ambitions in other areas to base policy on economic research. It is important that these ambitions apply in all spheres of economic policy.

- The Ministry of Finance should provide better supporting documentation, both internal and external, for its analyses.

Summary

The remit of the Swedish Fiscal Policy Council is to ”follow and evaluate goal achievement in the fiscal policy and economic policy adopted by the Government and Parliament.” This Report, which is our first, focuses on two principal areas: the *fiscal policy framework* and *employment policy*.

Long-term sustainability is an overall objective of fiscal policy. The surplus target and the expenditure ceiling are intermediate medium-term targets designed to facilitate achievement of that overall objective. Accordingly, it is appropriate that in this first report we analyze the design of the fiscal policy framework in relation to the aim of a fiscal sustainability. This kind of fundamental analysis is essential for evaluating the policy conducted in specific situations.

The objectives of increasing employment and reducing marginalization have been given priority by the current Government. That makes it necessary to form an opinion on the appropriateness of various employment policy reforms.

We also examine the change in real estate taxation and the elimination of the wealth tax. Finally, we provide some general comments on the supporting documentation for economic policy decisions.

The Government Should Provide Better Justification for the Surplus Target

The most important fiscal policy objective is meeting the fiscal surplus target. This target requires that the net lending (“budget balance”) of the general government sector averages one percent of GDP over the business cycle. The budget balance determines the development of general government finances over time. This affects in turn both the *distribution* of welfare *among different generations* and *social efficiency*, i. e. how much “aggregate welfare” there is to distribute among generations.

The demographic tendency of an aging population will place a heavy burden on public finances in the years ahead. One argument in favour of maintaining surpluses in general government finances at present is that they would make it possible to avoid tax increases later on. There is a strong efficiency argument for smoothing tax rates over time, as this minimizes the ever-present distorting and welfare-reducing effects of taxes. Current budget surpluses may also be defended on the ground that each generation should finance the government expenditure from which it benefits; if the currently active generation does not save for its own expenditure in old age, the burden is shifted to future generations. But this conclusion is open to dispute. One could also contend, for instance, that redistribution of income to the present generation from future ones is not unreasonable, as the former will probably have a much lower living standard than the latter.

In budget and spring financing bills, the Government has provided a number of motives for the surplus target, but no indication of the relative importance of different motives and no discussion of conflicting objectives. Instead, one gets the impression that the surplus target always facilitates simultaneous achievement of every economic policy objective, which is highly unlikely. It is impossible for a reader of the budget and financing bills to form an opinion on exactly how achievement of the surplus target will affect income distribution among generations. To illustrate this effect, the Ministry of Finance would need to develop systematic analyses showing how government policy redistributes income among generations.

In our view, there is a pressing need to justify the surplus target more clearly on the basis of more fundamental economic policy objectives. The Government should indicate more specifically the relative importance of different considerations: income-distribution goals, social efficiency and a precautionary motive of accumulating an asset buffer as a safeguard against adverse economic developments in the future. We believe that meeting this requirement is essential for maintaining the legitimacy of a surplus target in the long run.

Follow-Up of the Surplus Target Has Improved

As the surplus target has been rightly criticized for vagueness, it has been hard to determine the extent to which it has been achieved. One of the main points of criticism has been lack of clarity on what is meant by an "economic cycle," the period to which the target applies. In response, the Government has specified three different *indicators* to be used from now on:

1. The average net lending of the general government sector from the year 2000 through the latest year for which outcome data are available (the *retrospective indicator*).

2. A moving seven-year average of the net lending of the general government sector (the *moving-average indicator*). The seven years are the three preceding years, the current year and the three subsequent years. This indicator is thus based partly on forecasts.

3. The *structural* (cyclically adjusted) net lending of the general government sector for the current year, i. e. an estimate of net lending under normal cyclical conditions.

We take a very favourable view of the Government's attempt to provide clearer follow-up of the surplus target, and particularly the new moving-average indicator. With this indicator calculated for a fixed time horizon, the risk of manipulating the measure by choosing an "appropriate" length of the economic cycle is reduced. A way to reduce this risk might be to use forecasts of the National Institute of Economic Research (NIER) instead of the Ministry of Finance's own forecasts in calculating the indicator. But this would require that the NIER prepare longer-term forecasts than at present.

One possible criticism of the follow-up of the surplus target is that it is unclear what importance is given to the various indicators. It may not be possible to provide precise guidelines in advance on how to proceed if different indicators give different signals. But it would still be a welcome contribution if the Government could include a discussion of basic principles on this subject in the next budget bill.

Time to Review the Formulation of the Surplus Target

The current surplus target applies to the net lending of the entire general government sector. Thus formulated, the target can be viewed as a natural extension of the fiscal consolidation policy followed in the latter half of the 1990's, which focused on stopping the unsustainable increase in general government debt. When the surplus target was originally set in 1997, there was no room for fine-tuned considerations. Today there is much greater scope for fine-tuning in the formulation of the surplus target.

According to the Government's own sustainability calculations – as in the budget bill for 2008, for example – the surplus target is assumed to apply only until 2015. Thereafter, the tax ratio will be held largely constant, and the surpluses will gradually diminish as demographic developments lead to higher government expenditure. The targeted level of net lending will have to be revised in a few years. As long as this step is to be taken anyway, there is also reason to discuss in which terms the budget objective should be formulated.

A first issue is whether a budget objective should apply only to central government rather than the entire general government sector. One argument for this limitation is that both the pension scheme and the local government sector are autonomous systems governed by rules designed to guarantee financial stability: pension disbursement are to be adjusted according to pension contributions, and local governments are subject to a balanced-budget requirement. The main argument for continuing to apply the budget objective to the entire general government sector is that ultimately there is always political uncertainty about the stability of the current rules in times of crisis: the central government is of course the guarantor of last resort for the finances of both the pension system and local government sector. We do not find the arguments for a budget objective for central government alone sufficiently persuasive to recommend any change on this point.

Consider a Golden Rule for General Government Investment

There is an international discussion on whether a budget objective for the general government sector should apply to *total* saving rather than to *financial* saving (net lending) alone. Total saving is the sum of net investment and financial saving. Such an objective for total saving is referred to in international economic-policy discussions as a *golden rule*. The principal argument for a golden rule is that total saving determines the development of the *total net worth* of the general government sector, including the stock of real capital. This measure is probably more relevant than just the financial position for determining the state of general government finances.

The current target for net lending, and thus the requirement that investment be financed by taxes, probably causes current expenditure to crowd out investment, as it is then impossible to allocate the cost of an investment over its entire economic life. The main disadvantage of a golden rule it that it would be harder to verify goal-achievement. The reason is that opportunities may be created for circumventing the rules by reclassifying current expenditure as investment and manipulating the amount of depreciation.

There are many examples of targets for total saving instead of just financial saving (net lending), among them the UK, Germany and many US states. Sweden's balanced budget requirement for local government is also designed this way. Historically, moreover, Sweden has previously followed such a system in the central government budget. In the 1950's a distinction was drawn between an *operating budget* for current revenue and expenditure of Swedish central government and a *capital budget* for central government investment. In a normal cyclical situation, the current budget was supposed to balance, whereas the capital budget would be financed by borrowing.

In our opinion, the Government should appoint a commission to look into whether a future fiscal target could apply to the total saving of the general government sector rather than just net lending (financial saving) as at present. Any such change would require taking a position on the following points:

- An initial issue is whether all general government investment should be covered. Many public investments are socially desirable but do not produce any pecuniary return. Inclusion of such investments is justified if the primary interest is in income distribution among different generations. On the other hand, if the principal overall goal is to smooth tax rates over time for the sake of efficiency, only investments that yield a pecuniary return should be included. What boundaries should be drawn is a political decision based on the relative importance of different motives for a surplus target.

- The strongest possible guarantees should be constructed to prevent manipulation of any system with a target for total saving. The Swedish Parliament would have to set forth clear principles for this in the fiscal policy framework. It should then be a central task of the Swedish National Audit Office (Riksrevisionen) to monitor observance of these principles.

- It would be possible to combine a reformulated fiscal target for the total saving of the general government sector, with a minimum requirement for net financial wealth (or a maximum for net financial debt) of the general government sector. This model has been chosen in the UK.

- Since 1998, the Ministry of Finance has published long-term sustainability calculations for public finances, i. e. calculations showing whether projections of future general government expenditure would be compatible with unchanged tax rates. Such calculations would be even more important with a golden rule. This point can be underscored by including in the budget law a provision for a mandatory budget target and by requiring the Government to report annually to Parliament on how achievement of this target is contributing to long-term sustainability.

Budget and Financing Bills Should Provide a More Comprehensive Picture of General Government Finances

Regardless how the budget target is formulated, there should be readily accessible information on both the total saving (including saving in real capital) and the total net worth (including real capital) of the general government sector for anyone wishing to obtain an overall picture of the financial position of the sector. It is remarkable that such information is lacking in both the budget and spring financing bills.

Anyone looking for this kind of information must now instead turn to the annual report of Sweden's central government. But the development of net worth over a longer period is not shown there, either. From comparing the financial and national accounts (which we have used), on the one hand, with the annual report of the central government, on the other, it is evident that completely different principles of valuation are used; according to calculations based on financial and national accounts, net worth of the central government amounted to 5.2 percent of GDP (SEK 151 billion) in 2006, whereas according to the annual report, the figure was minus 22.4 percent of GDP (minus SEK 635 billion).

The conclusion is that the annual report of the central government does not provide adequate help to someone desiring a full picture of the country's public finances. There is no clear accounting to show the relationship between the concepts in the annual report and those used in the budget and financing bills. But the latter are the central documents of economic policy. It should be obvious to require that budget and spring financing proposals provide a readily accessible accounting of both total saving and the development of total net worth for the entire general government sector and its various subsectors. Such an accounting should not be hidden away in an annual report that is read by few and largely ignored in public debate.

The Role of Fiscal Policy in Cyclical Stabilization Should Be Clarified Further

A central question is to what degree discretionary fiscal policy, i. e. active decisions on measures to be taken, should be used to stabilize the cyclical development of the economy. A serious shortcoming of previous spring financing and budget bills was the lack of clearly formulated principles on this question. The spring financing bill of 2008 was a step forward. It affirms that the Riksbank has the primary responsibility for stabilization policy. According to the analysis, fiscal policy should normally operate exclusively via the automatic stabilizers, i. e. through automatic variations in tax revenue and general government expenditure due to cyclical developments. At the same time, however, it is argued in the spring bill that in some situations discretionary fiscal policy should be used for stabilization purposes. But in our view, it is very important that such situations be specifically defined.

In our opinion, two criteria should be met if discretionary fiscal policy is to be used to stabilize the economy. The first criterion is that the cyclical disturbance be of *sufficient magnitude*: fiscal policy is too crude an instrument to be used for fine-tuning the economy. For example, one might adopt a principle that the forecast output gap (the difference between actual and potential output) should be above or below a certain level.

The second criterion is that fiscal policy provide a *contribution in addition* to monetary policy (value added) i.e. that it can be expected to provide a greater degree of goal achievement in economic policy than if only monetary policy is used. An obvious situation of this nature is a recession where the normal arsenal of monetary policy has been used up once the Riksbank's policy interest rate is down near zero and thus cannot be lowered further (a so-called liquidity trap). Other reasons may be the existence of several stabilization policy objectives that cannot be achieved simultaneously through monetary policy alone. If for example it is considered desirable to avoid a reduction in resource utilization in a situation where there are strong inflationary tendencies, an expansionary fiscal policy may be preferable to an expansionary monetary policy; the inflationary effects of the latter would be greater, as it would likely result in depreciation of the Swedish krona.

But there are also other situations where fiscal policy measures may be preferable to monetary policy action if several economic policy objectives are to be achieved simultaneously. For example, there may be reluctance to lower interest rates in an economic downturn, for fear that this step might further drive up already over-inflated real-estate prices. If the goal is to cool off overheated sectors of the domestic market, a contractionary fiscal policy could be preferable to a contractionary monetary policy (since the latter would have a more general impact on the entire economy by affecting both interest rates and the exchange rate).

To assess the influence of fiscal policy on the resource utilization, good indicators are needed. The Ministry of Finance currently relies primarily on calculations of change in the so-called structural balance, i. e. the budget balance in a normal cyclical situation. However, this indicator is a very crude one that does not take into account the sharply differing effects of various fiscal policy instruments on resource utilization. There is a pressing need for the Ministry of Finance to develop better methods for so-called fiscal policy effect analyses that address these problems.

The Expenditure Ceiling Can be Made More Rigorous

The expenditure ceiling is set by Parliament for central government expenditure several years ahead; it excludes interest payments but includes pensions. While the expenditure ceiling has probably made it easier to achieve the surplus target, it has clearly not worked very well in a number of respects.

- The expenditure ceiling, which was originally to be set for the coming three years, has often been given a shorter range in practice.

- It has been unclear how the expenditure ceiling has been set.

- The role of the expenditure ceiling has been weakened by various measures that were actually intended to permit higher expenditure without formally exceeding the ceiling. This has been done by increased resort to devices like so-called tax expenditures, i. e by deviations from standard tax and contribution rates.

- The budgeting margin, i. e. the difference between the expenditure ceiling and budgeted expenditure, has often been used for the unintended purpose of financing reforms instead of cyclically dependent or other unforeseen expenditure.

The Government has announced a number of steps to bolster the credibility of the expenditure ceiling. One of them is to return to the three-year horizon for the expenditure ceiling and to avoid net budgeting, i. e. offsetting revenue against expenditure in certain budgeting areas. But further measures should be considered as well. Examples would include an overhaul of tax expenditure accounting to make it more transparent, as well as attempting to find a system where tax expenditure is regularly tested against a number of predetermined criteria. The purpose would be to subject tax expenditure to the same careful scrutiny as "ordinary" expenditure. There is also a need for clearer accounting to show how the Government's expenditure ceiling is calculated.

The purpose of the budgeting margin is to permit increased expenditure in case of cyclical downturns or other unforeseen events. But this margin has often been used for expenditure on new reforms without any relationship to cyclical changes in the economy or to other unexpected events. If the margin for increased expenditure is already committed, there is correspondingly less room for the increases in expenditure that tend to occur in an economic downturn, thus weakening the automatic stabilizers. Alternatively, the Government is forced to use various techniques for manipulating the regulatory framework for expenditure.

It would therefore be better to have two budgeting margins, one for cyclically dependent expenditure (*cyclical margin*) and one for other unforeseen expenditure (*reform margin*). The cyclical margin should be used only for cyclically dependent expenditure. The reform margin should be used only for expenditure on reforms and unforeseen expenditure that is not cyclically dependent. To avoid misusing a cyclical margin to finance new reforms, a clear provision should be included in the budget law that this margin is to be used only when the economy is weakening cyclically.

We have raised the question of a *golden rule* providing for a revised budget objective that would include total, not just financial, saving. If adopted, a golden rule should have consequences for central government expenditure. The expenditure ceiling should then cover only current expenses; it would not extend to investment expenditure, but cover only depreciation on investments. In that case it would be necessary to change accounting principles in the central government budget. There are two main types of accounting principles: cash-basis accounting and accrual-basis accounting. With cash-basis accounting an investment is recorded as an expense when it is made, whereas with accrual-basis accounting the investment is recorded as an asset and its expense is allocated over the economically useful life of that asset. In Sweden the central government has used accrual-basis *accounting* since 1993, whereas *budgeting* is still done partly on a cash basis. If the expenditure ceiling covered depreciation, but not investment expenditure, the same principle should apply to budgeting for the sake of consistency, i.e. budgeting should be done completely on an accrual basis.

There is reason to be highly critical of existing tendencies to circumvent the current expenditure framework by using budgeting techniques to create scope for increasing infrastructure investment; these entail borrowing from the National Debt Office or prepaying instalments on such loans. Practices of this kind arbitrarily exempt certain investment spending from the budgeting criteria that apply to other investment expenditure. In our opinion, either the current expenditure framework should be retained, thus ruling out such exceptions, or a golden rule should be adopted and consistently applied, permitting systematic debt financing of investment (or certain types of investment.).

Considerable Uncertainty in Sustainability Calculations

According to the latest assessment by the Ministry of Finance in this year's spring financing bill, fiscal policy is considered sustainable in the long term. At the same time, there is a significant margin for reducing taxes or, in the alternative, increasing expenditure. This margin, however, is not clearly shown in the calculations, but is concealed through a so-called "technical adjustment," meaning that future general government expenditure is assumed to increase permanently by five percent of GDP. The rise in level of expenditure is expected to take place gradually over the period 2011-2015. In our opinion, the Government should report the margin more clearly and also discuss its purpose.

We consider it risky to make use of the entire margin. Considerable uncertainty surrounds the assessed sustainability of fiscal policy. The uncertainty applies both to future developments and to the calculation methods used by the Ministry of Finance. The Ministry's calculations are based on a number of critical assumptions that may well prove overly optimistic. For example, the calculations do not consider the decreasing trend in average hours worked or the current cost pressure in health care and care of the elderly. Per capita consumption of health care and other government services is unlikely to remain constant as assumed in the sustainability calculations of the Ministry of Finance. Moreover, these calculations are based on the expectation that the labour market reforms implemented will generate a substantial increase in employment. Though not unreasonable, this assessment is of course very uncertain. The effects may well be much more limited than expected, particularly if future governments should revoke the reforms.

Based on the calculations of the Ministry of Finance as well as our own, our overall assessment is that that there is presently no reason to revise the current surplus target. On the other hand, it is obvious that the target (or a reformulated target for total saving if one is adopted) must gradually be lowered. The current surplus target is intended to reduce the future need for tax increases when demographic developments begin to have an impact. This thinking also underlies the Ministry of Finance's own calculations, in which the surpluses will start to decrease in 2015 and gradually turn into deficits. However, it is important to develop a credible plan well in advance for making these revisions.

One question that deserves more discussion is the degree to which a higher retirement age could justify maintaining a smaller current budget surplus. The primary cause of the demographic burden is that life expectancy is increasing whereas the (effective) retirement age is not being adjusted accordingly. If Sweden – as previously with Denmark – could index the retirement age to life expectancy, there would be less need to pre-save in order to cope with future weakening of the budget. Discussions on sustainability should focus more on this issue.

Net Lending Should Be Maintained at a High Level for the Next Few Years

The net lending of the general government sector is currently well above the target of one percent of GDP. As resource utilization was strained, a high level of saving was warranted in 2007. According to Government forecasts, both actual and structural saving will remain high for the next few years despite a weakening economy in 2008 and 2009. High government saving is not desirable in combination with a weakening economy. Consequently, from a stabilization standpoint alone, general government saving should be lowered toward the one-percent target when the economy softens. Furthermore, calculations of long-term sustainability indicate that the net lending of the general government sector can be reduced.

But since both the assessments of the economic situation and the sustainability calculations are surrounded by so much uncertainty, we generally agree with the Government's view that the current situation requires a high level of general government saving. In our opinion, the high degree of uncertainty about the long-term sustainability of fiscal policy makes it wise to provide large margins of safety. In these circumstances, it may be reasonable to keep general government net lending above the one-percent target until we have observed the effects of the employment policy reforms recently implemented and the impact of a weakening economy on calculations of structural saving. In the present situation, the Government should focus primarily on reforms that can be expected to have favourable supply-side effects and are not too costly in the short run.

Finance Ministry Forecasts No Worse than Those of Others – and No Better, Either

The Ministry of Finance prepares regular forecasts for the current and coming years. Unavoidably, these forecasts are often erroneous, but no more so than those of other leading forecasters. For economic policy planning, it is desirable to have forecasts with longer time horizons. One reason is that the ceiling on central government expenditure applies to the coming three years, and the Government has introduced a fiscal indicator that also extends three years ahead (the moving-average indicator). But for time horizons of two and three years, the Ministry of Finance prepares only economic projections, with no actual forecasts of future economic policy. We demonstrate that there is considerable uncertainty in these projections and that for this reason the moving-average indicator can give misleading signals regarding the achievement of the surplus target.

In recent years, the budget balance of the general government sector has been more positive than forecast. This unexpectedly favourable budgetary development has probably been due to higher economic growth and lower inflation than anticipated. Since these forecasting errors have probably made it easier to meet the surplus target, the disciplinary effects of the current fiscal policy framework may have been overestimated. With a cyclically weakening economy and rising inflation, there would probably be forecasting errors in the opposite direction. The financial framework would then face greater challenges than in the past decade.

Many Reforms in Employment Policy

The foremost objectives of the current Government are to increase employment and decrease marginalization. To attain them, the Government has implemented or announced a sizable number of employment policy reforms. To strengthen incentives to work, an earned income tax credit was introduced at the outset of 2007, followed by an enhanced credit a year later. Compensation levels in the unemployment insurance system have been lowered, and individual contributions have been raised. Also, reforms in the sickness insurance system have been implemented or announced.

For a given population, the number of hours worked can be increased in several ways. A larger proportion of the population can participate in the labour force, and a larger share of the labour force can be employed. But the total number of hours can also increase because more of those with jobs are actually working and more choose to work longer hours. At all these margins, the Government's employment policy reforms can be expected to affect the total number of hours worked in the economy. While the principal effects of the tax reduction on earned income are to reduce unemployment and to increase labour force participation, changes in the sickness insurance system will primarily improve presence at work among those who already have jobs. The reforms in unemployment insurance can be expected mainly to reduce unemployment.

In our report we evaluate the design of the various reforms in relation to the Government's objectives of increasing employment and the number of hours worked. We also study the consequences for income distribution. On the other hand, we take no position on the trade-off between employment and income distribution. The desirability of a measure that is effective in regard to employment, but increases differences in income, is a matter of political value judgment.

The Earned Income Tax Credit Will Increase Employment

The earned income tax credit is directed only at persons with income from work. Reducing the tax on earnings, but not on other kinds of income, increases the return on work and thus attracts more people to the labour force. When having a job becomes more desirable, greater moderation in wage negotiations may be expected. This will encourage firms to hire and will reduce equilibrium unemployment, i. e. the unemployment level compatible with a stable rate of inflation. It may therefore be assumed that employment will increase both because equilibrium unemployment decreases and because more people choose to enter the labour market. Estimates based on empirical research indicate that the tax reduction on earned income can in the long run lower the equilibrium rate of unemployment by nearly half a percentage point.

While it is very probable that the earned income tax credit will increase employment, the effects on income distribution are less obvious. On the one hand, income disparities will tend to decrease because individuals will have greater incentive to end their dependence on welfare benefits for support. On the other hand, differences in income will increase between those with work and those still on benefits.

In our calculations we have used an economic model that compares the effects of the tax reduction on earned income with alternative tax reforms such as elimination of the tax surcharge on high incomes or raising the threshold for the central government income tax. In our opinion, based on the Government's objectives, it is justifiable to prioritize the tax reduction on earned income over other ways of cutting taxes. More than the alternatives, the earned income tax credit provides a stimulus for higher labour force participation. The reason is that incentives for work increase for those with low earnings, who probably are especially responsive to a higher return on their labour. Moreover, a tax reduction on earned income probably pushes down the level of equilibrium unemployment, unlike abolition of the tax on high incomes or a higher threshold for the central government income tax.

According to our calculations, the threshold for the central government income tax could be raised at little cost to government finances. But such a reform would lead to greater disparity in income. Views on this question depend on political value judgments. As may be noted, other tax changes that cannot be expected to increase employment – primarily the reduction in real estate taxes – may already have claimed some of the "scope" for tax policies that widen the income distribution and may thus have made it politically more difficult to lower marginal tax rates for those in higher income brackets.

If the earned income tax credit is to achieve its intended effect, one prerequisite is that individuals can clearly see the increase in the return on their labour. We are critical of the complexity of the earned income tax credit as presently designed. It makes it hard for people to know in advance how large their tax reduction will be.

The Government Should Be Cautious about Additional Selective Tax Cuts

There is solid theoretical justification for tax cuts benefiting the provision of household services, although it is uncertain how extensive this tax relief should be to bring gains in efficiency. The principal argument is that market work is taxed but informal-sector work is not, resulting in too much informal-sector work and too little market work from the standpoint of social efficiency. . The drawback of tax relief for household services is that it leads to increased consumption of favoured services at the expense of other consumption. There is also the practical complication of drawing boundaries for what qualifies as a household service.

A number of reforms intended to improve the labour market situation of specific groups have also been implemented. These include the so-called New Start, Healthy Again and Gaining a Foothold (*nystartsjobben*, *nyfriskjobben* and *instegsjobben*) programmes as well as elimination or reduction of employer contributions for older individuals and for young people. The reforms provide tax cuts and subsidies for firms that hire the chronically unemployed, the chronically ill, immigrants, young people and older people.

Empirical studies have demonstrated that the transition to regular work is faster for beneficiaries of subsidized employment. But there is also persuasive evidence that subsidized employment crowds out regular employment to a considerable extent. Subsidized employment may nevertheless have positive net effects on employment if those who receive employment support have a weaker position on the labour market than those whose jobs are crowded out.

For group-specific tax cuts to have desirable employment effects, it is thus central that they actually focus on weak groups. The New Start, Healthy Again and Gaining a Foothold programmes clearly meet this criterion. By contrast, the reductions in employer contributions for young people, in our opinion, have not been very successful in this regard, and the measure is probably a rather ineffective way to increase employment.

Thus, reducing taxes for particular industries or groups may sometimes be justified, but at the same time, selective measures make it harder to understand the tax system. This can also lead to efficiency losses. We consequently find cause to be very restrictive about further selective tax cuts. We believe that the Government has nearly reached – or perhaps even passed – the point where selective tax reductions begin to have negative net effects on social efficiency.

Reducing Unemployment Compensation Will Lead to Lower Unemployment

Both the compensation levels and the financing of the unemployment insurance system have been reformed by the current Government. As from January 2007, income-related unemployment compensation decreases with the duration of unemployment. Moreover, the previously higher compensation for the first one hundred days of unemployment has been discontinued, equivalent to a reduction of slightly less than seven percent in the maximum compensation level.

According to well-documented research, a compensation level that decreases with the duration of unemployment can represent a reasonable balance between considerations of income distribution (insurance) and of employment. Studies of previous unemployment insurance reforms in Sweden show that the compensation level makes a difference in how long it takes an unemployed individual to return to work. Based on such studies, equilibrium unemployment will decrease by an estimated 0.4 to 0.8 percentage points as a consequence of the reduction in compensation levels.

We Are Strongly Critical of the Way That Financing Reform Has Been Implemented in Unemployment Insurance

The financing of the unemployment insurance system has been reformed twice during the current Government's term of office. The first step (effective January 1, 2007) led to relatively strong increases in individual contributions and some differentiation – though not much – in contributions among various unemployment benefit funds. A second step (to take effect on July 1, 2008) entails some reduction of individual contributions in most funds and, at the same time, greater differentiation.

The changes are intended to establish a link between the individual's contribution and the rate of unemployment in an unemployment benefit fund. An increase in unemployment among members of a fund caused by high wage increases is designed to result in higher individual contributions. Although the intention is good, the desired result is dependent on substantial overlap between unemployment benefit funds and wage bargaining areas. The overlap is only incomplete, thus weakening the influence of differentiation in individual contributions on collective bargaining.

There is reason to be strongly critical of the first step in changing the financing of unemployment benefit funds, which led to only marginal differentiation in individual contributions. As far as we can determine, this outcome was due to the Government's decision in advance to provide a specific amount for financing the first earned income tax credit. Meeting this need required a substantial increase in average member contributions. At the same time, there was a desire to put a ceiling on the increase. Policies in different areas conflicted. On the one hand, there was the intention to reinforce incentives to work through a lower tax on earned income. On the other, this reform was financed via higher individual contributions for working individuals while exempting the unemployed from the increases, directly offsetting the tax cut on earned income. The desired effect on incentives to work could have been achieved through a smaller earned income tax credit which would not then have required financing through general increases in individual contributions.

Since the increases in individual contributions were introduced, membership in unemployment benefit funds has dropped by 12 percent. This means that a large number of wage-earners now lack sufficient protection in case of unemployment – a potentially major problem in the event of a significant economic downturn. One way to manage the problem might entail mandatory unemployment insurance, as was the Government's original intent. However, it is uncertain at this time whether the Government and Parliament are prepared to push through such a reform after previous conflicts with trade unions over the unemployment insurance system. If not, the financing of unemployment insurance will have caused unintended change in the protection provided.

Question Marks about the Effects of the Sickness Insurance Reforms

Several reforms of the sickness insurance system have been implemented or announced. Employer co-financing of sickness benefits was abolished as of January 1, 2007. Moreover, the compensation level during the benefit period has been reduced by lowering the maximum benefit. The reform package in the budget bill for 2008 has several components. A central one is the so-called rehabilitation chain, which provides for testing work capacity and rehabilitation needs within time limits of three, six and twelve months.

The sickness insurance reforms can be expected to have positive effects on the number of hours worked. The problem – a poorly functioning insurance system and high absenteeism – is approached from different directions. The various components of the reform package are intended to create incentives for work, to strengthen the work capacity of sick-listed individuals and to increase the demand for labour that can be met by individuals who have been chronically ill.

It is far from obvious, though, how effective these measures will be. The package contains little that is new. An example: *on paper* the sick-listing procedure has long included fixed checkpoints, starting after only three months, for assessing work capacity in relation to the entire labour market. In practice, however, this provision has seldom been followed. The same applies to review of sickness compensation, which is always required in cases where the expected duration of sick-listing exceeds one year. Thus, protracted sick-listing periods have been tolerated despite all the rules that were supposed to prevent them. The question then is what guarantees that the new rules will be more strictly observed.

Financial incentives have been provided primarily for the individual. According to research, this can naturally be expected to have effects, but it is hard to believe that these will be sufficient to reduce sick-listing substantially. Other parties in the sick-listing process – employers, certifying physicians, county councils s and the National Social Insurance Agency (Försäkringskassan) – should also have incentives to prevent and to shorten periods of sickness absence. Probably employers are given inadequate financial inducement to comply with their obligation to help sick-listed individuals back to the labour market. Employers have the primary responsibility for employee rehabilitation, but there are no economic incentives to meet it.

Some of the reforms in sickness insurance can be criticized for lack of transparency. An example is the method for reducing sickness benefits through a decrease in benefit-qualifying income (BQI). The argument advanced in the budget bill is that sickness benefits should be based on past income instead of current income, and that the adjustment in BQI is the first step in this process. But the adjustment may be interpreted as a way to conceal deliberate reduction of the compensation level. Another example is the use of the term "rehabilitation," which can also be criticized for lack of transparency; the rehabilitation chain consists essentially of fixed points in time for determination of work capacity and a time-limited sickness benefit.

Reforms Considered to Have Positive Overall Impact on Employment

It is still too early to evaluate the effects of the employment policy measures implemented by the current Government. It will take time before these structural reforms achieve their full effect. Assessments at this point must therefore be based primarily on calculations in economic models. The increases in employment over the last two years are not due primarily to the Government's labour market reforms, but to the vigorous economic upswing that would have occurred anyway. On the other hand, the reforms may have helped to moderate wage increases. But the principal effects of the employment policy measures can be expected later on in the form of higher average employment over the economic cycle than would otherwise have been the case. This also means that possible future increases in unemployment in a coming economic downturn will not be an indication that the Government's employment policy reforms have failed.

The reforms can also be criticized for having often been prepared too hastily, forcing the Government either to take back proposals or to make further changes in the regulatory system. Presenting proposals that must later be withdrawn should of course be avoided, as it may give rise to expectational errors on the part of firms and households. Another consequence is that freedom of action in efforts to create the "optimal" system is restricted, as it may be politically difficult to change reforms that have already been approved. The reform process can thus result in suboptimal solutions. Proposals withdrawn or revised include changes in financing unemployment benefit funds, a benefit reduction rule in case of supplementary sickness insurance policies and a change in pension credit for persons with income-related sickness or early retirement compensation. The time limits for sick-listing in the budget bill for 2008 are a further example of revised proposals.

Inadequate Supporting Documentation for Reform of Real Estate Taxation

We have also examined the changes made in the real estate and wealth taxes. The primary purpose of taxing wealth is income redistribution, and the wealth tax has served as a progressive complement to the proportional taxation of capital income. With the abolition of the wealth tax, that progressive feature is no longer present in the tax system. In favour of abolition, there are strong considerations of efficiency. The wealth tax has been marked by exceptions, unjustified differences in valuation of various types of assets and the practical impossibility of taxing all assets. Investment in certain assets has thus been favoured over investment in other assets. However, the Government has not based abolition of the wealth tax primarily on these arguments, but on the ground that this step will promote new business by making risk capital more available. In a highly internationalized economy, however, there is only a tenuous link between opportunities for financing investment and the degree to which domestic households invest in shares and loans to business. Our conclusion is that there were strong arguments for abolishing the wealth tax but that those emphasized by the Government may not have been the most compelling.

From the preceding reference to internationalization, it may also be concluded that less mobile tax bases should be taxed more heavily. As real estate is one of these, the reduction in the real estate tax is obviously inconsistent with such considerations. The previous real estate tax was well supported by economic research and was also attractive from an income redistribution standpoint.

With the new rules for real estate taxation effective January 1, 2008, the Government clearly deviates from the basic principles of the tax reform in 1990/1991. To prevent distortion of investment among different assets, it is important that the return on all investment be taxed equally (principle of non-discriminatory tax treatment). Taxing residential capital less heavily than other capital assets creates an incentive to divert saving to the housing sector from other areas of the economy. This causes social inefficiency, unnecessarily reducing the return on the economy's resources.

Our calculations show how current and previous tax rules measure up to the principle of non-discriminatory tax treatment. We determine the effect of real estate taxation on the cost of capital for investment in housing compared to investment in corporations. The cost of capital is the required pre-tax return on new investment; it must suffice to cover the cost of financing as well as pay all taxes arising from the investment in question. The results show that taxation could be considered neutral after the tax reform of 1991. But under the rules effective in 2008, the cost of capital for an investment in a house is below the assumed real rate of interest. This probably means that the net effect of the tax system is to subsidize such investment. The new rules thereby provide an incentive to channel a larger share of investment into the housing sector, reducing the efficiency of the economy as a whole. For this reason, we are highly critical of the changes in real estate taxation. As previously designed, the real estate tax admittedly had its problems, but solving them should have been possible within the basic regulatory framework of the earlier tax reform, for example through the sort of limitation provisions that already existed.

Compared to the relatively high level of ambition in basing employment policy on qualified research, there is a remarkable lack of similar ambition for taxation of real estate and wealth. There is no research to support the Government's declared reasons for the reduction of the real estate tax. This shortcoming sharply contrasts with the careful study that preceded the tax reform of 1990/1991.

One major drawback of the special reduction in the real estate tax is that it tends to increase disparity in incomes and net wealth without any beneficial effect on employment. In this way, the margin for reducing the central government income tax in higher income brackets – which has much more harmful effects on the incentives for work and education – has been unfortunately restricted.

Suggestions for Improving the Supporting Documentation for the Government's Proposals

The remit of the Swedish Fiscal Policy Council includes examining the supporting documentation for economic policy. Much of this documentation consists of internal working papers of the ministries. We have reviewed materials of this nature at the Ministries of Finance and Labour in connection with interviews.

Our observations on the documentation for decisions of economic policy lead to the following recommendations:

- More time and resources should be devoted to internally documenting the analyses performed by the Ministry of Finance. At present, insufficient documentation sometimes makes it difficult to recreate exactly how previous analyses were conducted.

- To a greater degree, the Ministry of Finance should publish its analyses. An appropriate form would be a series of reports, where individual officials could publish qualified analyses under their own names in a manner similar to the practice followed in many international organizations. This would help to enhance the quality of work at the Ministry of Finance and also to provide better documentation for use in public debate.

- The spring financing and budget bills should analyze not only the proposals presented, but also alternative ways to design the proposals. This is a prerequisite for determining whether a particular reform is the one that accomplishes its purpose at the least possible cost.

- The current Government has expressed its ambition to base policy on research results. While welcoming these intentions, we note that they have been followed in some areas but not in others, such as real estate taxation. We are highly critical of this selective reliance on research results. Naturally, there are similar needs for documented research in all areas.