Swedish Fiscal Policy

Report of the Fiscal Policy Council 2009

Principal Conclusions and Summary

Principal conclusions of the report

The report focuses on two main issues:

1. How well has the Government succeeded in adjusting fiscal policy to the dramatic cyclical weakening?
2. How should the economic policy frameworks be further developed?

Our principal conclusions are:

- Government measures to handle the financial crisis itself have generally been adequate. But there needs to be a more thorough analysis of the risks of increased government lending and various guarantee schemes.
- An assessment of the Government's measures in face of the recession must weigh the advantages of taking measures now to address the fall in employment against the risks of a higher budget deficit. The large downward revisions of economic forecasts since the Budget Bill justifies, in our opinion, stronger stimulus measures this year than those taken up to now.
- Additional stimulus measures beyond those announced by the Government should probably be taken in 2010. The stimulus measures should include a further temporary increase in the central government grants to local governments and a *temporary* increase in unemployment benefits.
- The expenditure ceiling should not block central government expenditure if there are compelling cyclical reasons for allowing it to increase. It would be desirable to get a cross-party agreement on the possibility of exceeding the ceiling in *exceptional* circumstances.
- It is appropriate, as the Government is doing, to expand labour market policy measures for the short-term unemployed. But the Government has an overoptimistic view of what job search activities can achieve in a deep recession.

- The expansion of the job and development guarantee is not a forceful labour market policy measure, but a consequence of having to provide welfare benefits to support more long-term unemployed. It will be difficult to provide the guarantee with enough meaningful content for the majority of participants.
- There is too little labour market training. It is wise to keep volumes substantially lower than in the 1990s but there is nevertheless room for an expansion without impairing effectiveness. Temporary central government support for training in firms should be possible where agreements on shorter working hours and corresponding wage adjustments have been reached.
- Unemployment insurance should be made *cyclically dependent*, so that the benefit level is higher in a recession than in a boom. The need for insurance is greater in a recession. At the same time, job-search incentives play a smaller role.
- Reporting of the total worth of the general government sector is still inadequate in the Budget Bill and the Spring Fiscal Policy Bill. Reporting of general government investment is so incomplete that the Riksdag (the Swedish Parliament) does not have a satisfactory basis for decision making.
- The review of the fiscal framework now under way must clarify the overall objectives behind the surplus target. The framework should provide a clearer picture of the balance to be struck between *pre-funding* and a gradual *increase in lifetime working hours* as methods of meeting the future demographic pressure on expenditure.
- A gradual rise in lifetime working hours should be part of the strategy for meeting the demographic strains. One way to achieve this is an automatic adjustment of the retirement age to life expectancy. Such a link could make possible a budget objective that is less ambitious than the current surplus target.
- Reforms to reduce the labour market entry age are desirable. These reforms could take the form of generally higher study support, more generous study support for younger students than for older students, and a reduction in the ceiling for earned income (the exempt amount) in the student support system.

Summary

The past year has witnessed a uniquely rapid and deep deterioration in the economy. In a short time it has fundamentally changed the conditions for both fiscal policy and other economic policy. Stabilisation policy considerations now play an important role that could not have been predicted only a year ago. The change in the situation makes it natural for our review to focus on two principal questions:

- How well has the Government succeeded in adjusting economic policy to the new conditions?
- How should the work ahead to develop and improve the rules system governing economic policy be conducted?

The two questions are intimately connected. The economic crisis brings a number of issues about the design of economic policy frameworks to a head. At the same time, it is essential to keep a long-term perspective so that the goals of a sustainably high level of employment and sustainable public finances can be achieved. A long-term perspective is also essential for the short-term credibility of fiscal policy and thus for its effectiveness. This means that the Government's work on developing fiscal and employment policy frameworks should continue in the current situation.

Fiscal policy in the recession

The fiscal policy for 2009 was mainly determined in the Government's Budget Bill in September 2008. At that time, a limited economic slowdown was expected. The Government predicted that GDP growth would fall to 1.3 per cent in 2009 and that a GDP gap, i.e. a difference between actual and potential GDP, of –1.7 per cent would emerge. At the same time, general government net lending in 2008 was expected to be 2.8 per cent of GDP. Since this was substantially above the surplus target of 1 per cent of GDP, the Government considered an expansive fiscal policy appropriate. The budget proposal therefore involved a reduction in structural net lending (cyclically adjusted net lending) of about 1 per cent of GDP

in 2009. The expansive measures included a third step in the earned-income tax credit, a higher tax threshold for the central government income tax, a general lowering of social contributions and an extension of the earlier reduction in social contributions for young people. Our opinion is that the fiscal policy in the Budget Bill, given the information on the cyclical situation then available, was well balanced.

Since the Budget Bill was presented, there has been a drastic downward revision in the economic outlook. The estimate in the Spring Fiscal Policy Bill is now that GDP growth in the current year will be –4.2 per cent. This is expected to mean a negative GDP gap as large as 7.1 per cent. The fall in GDP is reckoned to come to an end in 2010 but resource utilisation is expected to continue to decline. Unemployment is expected to rise with some lag, reaching almost 12 per cent in 2011. For Sweden, this economic crisis is fully comparable to the crisis in the 1990s. The primary difference is that the crisis this time has not been triggered by events in the Swedish economy but by developments elsewhere in the world.

A key issue is how to assess fiscal policy in its current form in relation to the dramatic deterioration in the cyclical situation since autumn 2008. The Government has taken some further fiscal stimulus measures in a supplementary bill in January this year and in the Spring Fiscal Policy Bill. For 2009, these primarily include some increase in general government investment, the introduction of a permanent RMI (repairs, maintenance and improvement) deduction and more resources for labour market policy. The measures are limited in size. They correspond to about 0.3 per cent of GDP for 2009. In 2010 local governments will receive a temporary increase in central government grants of SEK 7 billion.

Stronger fiscal stimulus measures are desirable

The deep recession also entails a significant deterioration in general government finances. In the Spring Fiscal Policy Bill, the Government forecast a deficit in net lending of 2.7 per cent of GDP in 2009 and 3.8 per cent in 2010. The deficit in 2010 is thus expected to exceed three per cent of GDP, the deficit ceiling under the EU's Stability Pact. Under an escape clause in the Pact, however, this ceiling can be exceeded temporarily in an economic situation like the current one. The reversal in net lending is primarily due to the automatic stabilisers; that is, it is a result of reduced tax revenue and increased expenditure on unemployment and other benefits that automatically occur in an economic downturn.

A common view expressed in the economic policy debate has been that the tax cuts and cuts in unemployment and other benefits in recent years have weakened the automatic stabilisers. According to our calculations, such a weakening has occurred, but it is small.

The cyclical weakening is obviously so great that the policy options to combat it are limited. We share the Government's opinion that it is impossible to prevent the economic downturn from having a major impact on output and employment in Sweden. Instead it is a matter of weighing at the margin how big a fiscal stimulus should be deployed and how large a budget deficit should be accepted.

There are at least three strong arguments contending that the Government should have conducted a more expansive fiscal policy:

- The reforms in the Budget Bill were not primarily designed to stimulate the economy but more with the aim of contributing to long-term economic efficiency. This is true, for example, of the tax cuts resulting from the increase in the tax threshold in the central government income tax. High-income earners can be expected to consume a lesser share of a tax cut than low-income earners.

- The drastic cyclical deterioration since autumn 2008 means that we will experience a much sharper fall in output and employment than could be foreseen at that time. If the basis for action even then was that fiscal policy should take the cyclical situation into account, a dramatic deterioration in the economy should have meant stronger doses of economic stimulus.

- The unemployment insurance reforms – which can be expected to have positive long-term effects on employment because they help improve the functioning of the labour market – have at the same time meant that there is less insurance in the event of unemployment. This means that the consequences of increased cyclical

> unemployment will be very serious. It is therefore more important than before to fight cyclical unemployment with stabilisation policy.

At the same time, there are highly respectable arguments for a more cautious approach. Sizeable fiscal stimulus measures that lead to permanent large budget deficits may jeopardise the long-term sustainability of fiscal policy. The effects of *temporary* large deficits – which could occur, for example, if some of the central government's sizeable guarantee commitments were to be triggered – on the long-term sustainability of general government finances, are, however, small. The greatest risk is that what is initially cyclical unemployment will eventually grow into persistent unemployment. Because of the relatively strong automatic stabilisers, general government finances are more vulnerable to such a development in Sweden than in most other countries. The risk of persistent unemployment, however, is reduced by the contribution that the fiscal stimulus measures make to keeping unemployment down now.

A bigger problem is that the recession may well be both very deep and quite protracted. If so, too big a stimulus in the current situation could limit the room for additional stimulus measures at a later date when there may be an even greater need. The deficits may also raise expectations of future tax increases, which might induce households to save more. This could have contractionary effects later on. Such effects also occur if doubts about the credibility of fiscal policy drive up long-term interest rates.

When we weigh the various risks against each other, it is our opinion that additional fiscal stimulus measures would have been – and are – desirable. The deficits in Sweden are considerably smaller and the financial position (both net financial worth and gross debt) better than in most other OECD countries. The financial position of the general government sector is also stronger than it was at the beginning of the crisis in the 1990s. Furthermore, there is now a fiscal framework with a relatively high level of credibility and a broad political consensus on the need to safeguard the long-term sustainability of general government finances. This gives fiscal policy room for manoeuvre that should be exploited.

Appropriate additional fiscal stimulus measures

It is important for additional fiscal stimulus measures to be cost effective: the demand and employment effects should be as large as possible in relation to the costs. One such measure is additional temporary central government grants to *local governments*. In our opinion, more funds should be provided even in the current year with the aim of avoiding layoffs. It is presumably less expensive to reach a certain level of employment by preventing layoffs than by stimulating hiring later. We also share the National Institute of Economic Research's assessment that the additional resources provided next year should be larger than those proposed in the Spring Fiscal Policy Bill. The research literature indicates that public consumption has a substantial effect on aggregate demand. There is, of course, a risk that local governments will save some of these additional resources and not use them for consumption. But if so, there will not be any deterioration in general government finances as a whole: net lending is simply transferred from one part of the public sector (the central government) to another (local government).

Further stimulus measures should mostly be directed at low income groups expected to have a high propensity to consume. One such group is the *unemployed*. In our previous report, we concluded that the reduction in unemployment benefits carried out will markedly lower unemployment in the long term. This will take place because the incentives to find a job and to restrain wage increases are strengthened when the return on work increases. This is crucial for high employment in normal economic times when unemployment is mainly due to deficiencies in the functioning of the labour market. But in an extreme economic downturn, when unemployment increases sharply owing to a lack of demand, and there is substantial wage restraint, the incentive effects play a much smaller role for employment than they normally do. This may be an argument for a *temporary* increase in the level of unemployment benefits. This could be done, for example, by extending the period (currently 200 days) when benefits amount to 80 per cent of the previous wage. Such an extension could remain in effect for two years, for example.

One obvious problem with a temporary rise in the benefit levels is that it may be difficult to lower it again once the economy picks up. For long-term employment, it is important that a future reduction does, in fact, take place. It would therefore be desirable if a decision on a temporary change could be taken as part of a cross-party agreement on making unemployment insurance permanently dependent on the business cycle. This is discussed at greater length later in the summary.

In the unemployment insurance, there is also a minimum and a maximum daily amount for the benefit: the basic allowance and the ceiling. These amounts do not follow general income developments. Instead they are changed by discretionary decisions by the Riksdag. However, this has not happened since 2002 when both the basic allowance and the ceiling were raised. So that unemployment benefits will not continue their gradual decline in relation to wages – which would be unreasonable – a decision on raising the levels will eventually be required. It may be appropriate to take these decisions during the recession now under way.

One further measure that should be considered is a permanent increase in *study support*. It has fallen sharply in relation to the average wage since the beginning of the 1990s. According to our analysis of the incentives for getting an education and completing it in a short time, an increase in study support is justified in the long term. It is also timely to raise the support during a recession.

In addition, the 'brake' in the pension system will be applied in 2010. Under the previous regulations, old-age pensions would have fallen by 3.5 per cent next year. This would be unfortunate in the course of an extreme economic downturn. The Government parties and the Social Democrats have reached an agreement on a rule change that results in a smoother development of pensions. We are, however, sceptical towards this change since it is important not to undermine the credibility of the rules guaranteeing that pension expenditure will be adjusted to the pension system's resources. It would seem more appropriate to first take other measures, for example *time-limited* targeted tax cuts, to temporarily maintain pensioners' income during the current cyclical situation.

Possible further stimulus measures could take the form of support for improving the municipal housing stock. Another possibility would be a temporary tax credit for low-income earners.

All recommendations on the appropriate level of fiscal stimulus have to be based on uncertain assessments of various risks and expected effects of various stimulus measures and relative evaluations of different objectives. Additional stimulus measures, had they already been taken in 2009, would have been able to dampen the upturn in unemployment somewhat. Larger temporary stimulus measures this year of up to 0.5 per cent of GDP (SEK 15 billion) would hardly present any problems for the credibility of fiscal policy.

Further stimulus measures are also, as far as we can see today, appropriate in the course of 2010. On the basis of the Government's own calculations, temporary stimulus measures of 1 per cent of GDP (about SEK 30 billion) mean a structural (cyclically adjusted) net lending of around zero next year. All estimates of the structural budget balance are naturally quite uncertain, particularly in a situation like the current one. But a stimulus policy that in an extreme economic downturn aims at limited deviations from the surplus target of 1 per cent of GDP should not mean unacceptably high risks of fiscal sustainability. On the contrary, it is natural for structural net lending to fall short of the surplus target in a severe recession. In our opinion, there is room for temporary stimulus measures beyond those announced by the Government.

The Government has too much confidence in the effectiveness of labour market policy

Labour market policy reforms have been a key feature of the Government's economic policy. When the reforms were designed, the primary aim was to reduce the high unemployment that persisted despite the economic boom. The policy has had two main elements: one is more effective matching between the unemployed and job vacancies by putting more focus on employment services and on increased job search activity by the unemployed. The other main element is the use of targeted measures to reduce the *stock* of long-term unemployed people.

The acute economic crisis confronts labour market policy with problems that are to a large extent different. It is now also a matter of dealing with a very large *inflow* into unemployment and trying to prevent it from leading to a persistent increase in long-term unemployment, and thus of total unemployment, in the long run. This is reflected in the increased resources that the Government is now giving to the Swedish Public Employment Service to help the short-term unemployed, primarily by coaching and traineeships. At the same time, subsidies to new start jobs directed at the long-term unemployed, who now find entering the labour market during a recession even more difficult than during a boom, are being doubled. In our opinion, these changes in the labour market policy are highly appropriate in the current situation.

The scale of what today are classified as active labour market policy programmes will, in the Government's opinion, increase dramatically in the next few years. Around five per cent of the labour force is expected to participate in various programmes in 2010-2011. This has been presented as an exceptionally forceful labour market policy measure. We find this assessment very questionable. The higher programme participation is mostly a purely mathematical consequence of the increase in long-term unemployment: more unemployed have to be offered places in the job and development guarantee so that they are not without a means of support.

What real content can be injected into the guarantee in a situation with high unemployment and few job vacancies is an open question. It is desirable to keep the unemployed active and try to achieve as even a distribution of unemployment as possible. The concern is to avoid concentrating unemployment among a core of marginalised long-term unemployed. But past experience makes it hard to believe that meaningful job search activities can be found for the large majority of unemployed people when there will be so many in this situation. With low labour demand, it will presumably also be difficult to come up with a large number of traineeships. The Government's intention of pursuing 'a policy involving a broad range of active measures' will therefore be very difficult to fulfil: quite the opposite policy is more likely to be the result. Activation schemes cannot be successfully implemented simply by changing the designation of long-term unemployment.

The Government appears to put too much faith in the expectation that the changes in the labour market policy will make it more effective. It would be more reasonable to acknowledge that the policy faces an almost impossible task.

Labour market training should expand

It is positive that the Government is well aware of the risks of expanding those labour market policy programmes that may have large locking-in effects. At the same time we are critical of keeping labour market training at such a low level: only about 5 000 people at present. Instead the Government is focusing on an expansion of vocational education and training in the regular education system (adult vocational training).

The Government's negative attitude towards labour market training is presumably related to the disappointing results during and after the crisis in the 1990s. Those results were due in part to the extensive use of labour market training at that time to re-qualify participants for unemployment benefits. This is no longer possible. Another likely explanation for the disappointing results in the 1990s is the extreme size of the programmes. In our opinion, it should be possible to expand vocational labour market training to at least 15 000 places without any efficiency problems. This assessment is supported by the good results shown in evaluations in recent years.

There is no reason to see labour market training and vocational education in the regular education system as substitutes. They should instead be seen as *complements*. There are good reasons for, as the Government is doing, increasing the number of places in adult vocational training. But it would probably be wise to raise benefits, at least on a temporary basis, to the unemployed beginning such training to make the incentives for choosing the training stronger: for many unemployed, study support is currently considerably less than unemployment benefits and activity support (even though it is somewhat more generous than ordinary study support).

A much discussed issue is whether the central government should provide support for training within firms. The main argument *against* this is that it is inappropriate to lock in labour in stagnating economic activities since this may slow down desired structural change. One argument *for* such training in the current situation is that for most firms, the reduction in demand is likely to be cyclical. One possibility would be for the central government to provide support only for the costs of arranging training in firms where agreements have been concluded with the union on shorter working hours and scaling down wage income correspondingly. Such an agreement is an indication that employers have deemed it likely that the downturn in demand is cyclical and that in the future, they will need the labour not made redundant.

Perspective on youth unemployment

The Government has taken special measures targeting youth unemployment. Social contributions for young people were lowered back in 2007. This year, that reduction has been broadened. It is also natural that concern about high youth unemployment is growing now since young people and others entering the labour market are particularly hard hit in an economic downturn.

Youth unemployment, like all other unemployment, is an extremely serious problem, both for society and for the individuals concerned. But it is not self-evident that unemployment is worse for young people than for older people. On the contrary, research shows that during the crisis in the 1990s, youth unemployment was much less persistent than unemployment among older workers. There are also plausible reasons why there is higher unemployment among young people. It is due partly to the time it takes to find a job when entering the labour market and to young people trying out various jobs.

Unemployment spells are in general much shorter for young people, which indicates that the labour market functions better for them than it does for older workers. That being so, broad measures aimed at lowering youth unemployment may have undesirable effects: older workers may be crowded out into more prolonged unemployment. This may cause an increase in total unemployment. As in last year's report, we are therefore critical of the selective reductions in the social contributions for young people. The reductions violate the general principles that otherwise guide the Government's employment policy and that entail selective support measures targeted at those who have been unemployed the longest.

Measures aimed at youth unemployment should, in our opinion, be targeted at the group of young people with little education, who have considerable difficulty getting established in the labour market. But measures should mainly be taken in the labour market and education policies, not in tax policy. We are therefore positive to the job guarantee for young people that – in accordance with earlier policies in Denmark – is aimed at activation initiatives, particularly education and training. We also welcome the changes in education policy, which entail apprenticeships in the upper secondary school and a more vocational orientation in both upper secondary school studies and adult education.

The economic crisis brings several system changes to the fore

The acute financial crisis has brought to light several shortcomings in various rules systems that need to be remedied. These primarily concern the expenditure ceiling, the balanced budget requirement for local governments, unemployment insurance, and the crisis management system for the financial markets.

Allow temporary exemptions from the expenditure ceiling

Under the Budget Act, the Government may choose to use expenditure ceilings. The ceilings then specify the maximum level for the majority of the central government and the old-age pension systems' expenditures. Before the economic crisis, the current Government had specified expenditure ceilings for 2009-2011. However, central government expenditure is rising when the economy is deteriorating, particularly as a result of the rising unemployment but also as a consequence of various expenditure measures. The expenditure ceilings may therefore restrict economic policy's room for manoeuvre in the coming years.

The expenditure ceiling is established by the Riksdag, but it is not legally binding. One issue that has come to the fore as a result of the economic crisis is therefore whether the Government will stick with the ceiling established earlier or if higher expenditures will be permitted in an exceptional situation.

It is our opinion that the expenditure ceiling should not be defended at any price during a deep recession. The expenditure ceiling has no value in itself. It is a help in achieving an efficient fiscal policy. The underlying idea is primarily to avoid unplanned large expenditures in good times when tax revenues are higher than expected. If in a deep recession the regulatory framework instead limits the policy so that it is obviously ineffective, the short-term cost of keeping the ceiling, no matter what the economic situation, is too high.

If the expenditure ceiling is revised upwards in an orderly manner, the credibility of the fiscal policy framework need not be markedly weakened. If the ceiling is to be revised, the Government should try to get as much support as possible in the Riksdag for an agreement on the principles to apply in such a revision. The Government and the Riksdag should, in our opinion, as soon as possible declare that the expenditure ceiling need not be followed during an exceptional recession like the current one, despite there being no urgent reasons at present for reconsidering the expenditure ceiling for 2010. Delaying such a declaration risks damaging the ceiling's credibility. The Government has already begun circumventing the rules by choosing to disburse the increased central government grant to local governments for 2010 already in 2009. An honest and clearly justified deviation from a previously established ceiling is preferable to such manipulation. Moreover, there is a risk that economic policy may not be designed in the best way if the expenditure ceiling is defended to the very end. In the current recession the Government might, for example, be forced to choose less effective stimulus measures in the form of tax cuts rather than stimulus measures that raise expenditures.

Central government grants to local governments should be cyclically adjusted

In accordance with the *balanced budget requirement* for local governments, the budget is to be drawn up so that revenue exceeds expenditure. The balanced budget requirement means that local governments' possibilities of pursuing stabilisation policy are very limited. In practice there is a risk that local government policy will be pro-cyclical, i.e. it will be more expansive in an economic upturn and tighter in an economic downturn. The reason is that local governments' tax revenues fall when the economy is weak. To meet the balanced budget requirement, local governments may thus be forced to save in an economic downturn. This is unfortunate from a stabilisation policy perspective.

For local government resource utilisation not to amplify cyclical swings under the current regulatory framework, central government grants to local government should be adjusted to the cyclical situation. These grants are not indexed to economic growth but are changed from one year to the next by discretionary decisions by the

Riksdag. One way of achieving a well-designed economic policy is therefore to let central government grants be higher during recessions and lower during periods of strong economic growth.

It would be desirable to change the rules system. The Government has indicated that the balanced budget requirement may be relaxed to permit local governments with well-managed finances to plan for deficits in bad years. We see problems with such a change and think that the central government should retain responsibility for stabilisation policy. It would make this task easier if the current system of discretionary decisions on local government grants were replaced by a regulatory framework in which central government grants were automatically cyclically adjusted to smooth out short-term fluctuations in the aggregate tax base of local governments.

Make unemployment insurance cyclically dependent and mandatory

Unemployment insurance is intended to provide individuals with income protection in the event of unemployment. At the same time, benefit terms affect the unemployment level since a more generous benefit leads to both longer periods of unemployment and higher wage levels than would otherwise prevail. It is therefore necessary to strike a balance between the objective of providing insurance protection and the objective of creating incentives for low unemployment. The reduction in unemployment benefits that has been introduced is likely to lead to a substantial reduction in unemployment in the long run.

It may, however, be argued that the balance between the insurance and incentive motives should vary according to the cyclical situation. While there are lesser incentive problems during a recession, there is more need for insurance then than there is in a boom: no matter how intensively the unemployed search for work, the fewer the job vacancies, the less job-search activities matter for the aggregate employment level. This is the argument for a *cyclically dependent* unemployment insurance with more generous benefits in a recession than in a boom. The unemployment insurance schemes in the United States and Canada are designed in this way.

In our opinion, cyclically dependent unemployment insurance should also be introduced in Sweden. This could be done, for example, by a slower decrease of unemployment benefits over the unemployment period for an individual in a recession and an increase in the basic allowance, which is not income-related. The system should be rule-based so that pre-determined changes are triggered automatically when the unemployment level deviates by a specified number of percentage points from the average during, for example, the preceding two years. Cyclically dependent unemployment benefits would strengthen the automatic stabilisers in fiscal policy.

Making unemployment insurance cyclically dependent cannot be done overnight. That is why we proposed a *time-limited* extension of the initial period with the highest replacement rate earlier in the discussion.

As in last year's report, we again feel very concerned about the decline in the number of people who are members of the unemployment insurance funds owing to the increase in membership fees. Admittedly, the deterioration in the cyclical situation will lead to a reversal of this outflow to some extent, even though the higher unemployment means higher membership fees. Raising the membership fees in the current situation is unfortunate since it weakens the automatic stabilisers. We would prefer a system where the average unemployment insurance fee was made independent of the cyclical situation but a differentiation of the fees depending on the unemployment in the individual funds is retained.

In our opinion, it would be best in the long run to make the unemployment insurance a mandatory, central government social insurance covering all employees. There are two main reasons for this. One is to guarantee everyone, including low-income earners at high risk of unemployment who perhaps would otherwise consider themselves unable to afford insurance, adequate protection against unemployment. The other main reason is ensuring that everyone contributes fully to the insurance, even high-wage groups with low unemployment risk. This is the same argument that has been used to justify obligatory central government sickness and pension insurances. In principle, there are no reasons for taking a different view of unemployment insurance.

The crisis management system for the financial markets needs to be designed more carefully

The turmoil in the financial markets last autumn forced emergency measures on the part of the Government, as well as the Riksbank, the Swedish National Debt Office and the Swedish Financial Supervisory Authority. Well-functioning financial markets are vitally important to all sectors of the economy. If firms and households are unable to get credit, the whole economy risks collapsing. It is therefore necessary for the authorities to intervene with various support measures in the event of big shocks in the financial markets.

The Government has responded by introducing a stability plan and a recapitalisation scheme for commercial banks, by providing the conditions for more central government lending and credit granting, and by allowing temporary tax deferrals for firms. These measures have mostly been appropriate.

One criticism that can be directed at both the current and previous governments, however, is that when the crisis began, there was no satisfactory legislation for handling financial institutions in crisis, though the need for such legislation had been noted after the Swedish bank crisis in the 1990s. Legislation has now been hastily drawn up and the Ministry of Finance has been compelled to allocate resources for this work. In the absence of a special government authority that could deal with the financial institutions in crisis, the National Debt Office has been given this role.

It is in principle questionable whether the Debt Office is the right body to handle financial institutions in crisis even though it currently happens to have a management with considerable experience of similar problems from the 1990s crisis in Sweden.

The Debt Office has now been given responsibility for the bank guarantee and other types of support and guarantees to financial institutions. Exercise of this authority is to be combined with the Debt Office's traditional tasks of borrowing in the market from firms and households and through various financial institutions, reaching agreements on debt exchanges with various maturities, and investing any liquidity surplus in the market. The same financial institutions will now both have a business relationship with the Debt Office and be subject to the exercise of its authority.

Assigning business responsibilities and the exercise of government authority to the same agency is, in our opinion, inappropriate.

Against this background, we recommend transferring the exercise of authority from the Debt Office to a new independent agency.

The stability plan also includes a voluntary *guarantee programme* that enables solvent banks to purchase central government guarantees for their medium-term borrowing for a limited time and an obligatory *stability fund* that will help finance future central government support to banks in crisis. Only a few financial institutions have joined the guarantee programme. This has led to criticism. One alternative would have been to make participation obligatory. Since banks can decide to join at a later date, the programme has still served a useful purpose even though direct participation has been low.

We also agree that there is a need for some form of obligatory stability fee (or 'bank tax'). This fee is justified since financial institutions occupy a special position that may warrant central government support in times of crisis. The banks should finance future support measures through fees paid when their activities are not in crisis. How best to design the stability fees is, however, a complicated issue. One lesson from the current financial crisis is that the regulations and fee structures must be carefully considered, for example so that they do not provide incentives for excessive risk-taking. Since the stability fees are not part of the acute crisis management, there should be further study of their design before they come into effect.

Shortcomings in general government reporting

General government investment as a share of GDP has declined from about six per cent at the beginning of the 1970s to about three per cent in recent years. This development is primarily due to the reduction in investment by local governments as a share of GDP. In the government budget bills, there is no analysis of the development, level and distribution of public investment. This makes it extremely difficult to judge whether the level of public investment is appropriate. The Riksdag has, quite simply, no satisfactory basis for making decisions on such matters. This needs to be substantially improved.

Reporting of the capital stock of the public sector, and thus the sector's total net worth, is still unsatisfactory. Admittedly, this information has been included in the Budget Bill for 2009 and the

2009 Spring Fiscal Policy Bill for the first time. But the information is reported at the end of the Bill and appears not to play any role whatever in fiscal policy considerations. Moreover, the information is reported entirely without comment.

One urgent issue concerns the risk-taking involved in the central government's support measures for the financial system. These include guarantee commitments, loans and capital injections. To be sure, the Spring Fiscal Policy Bill reported all the support measures, but it is still difficult to get a good picture of the risks. This is partly due to the nature of things since uncertainty about the future course of the crisis is genuine. However, a much more penetrating analysis of various alternative scenarios based on previous experience with financial crises in different countries would be desirable. Such elaborated analyses should be included in the forthcoming Budget Bill.

The surplus target is unclear

The surplus target is the most important long-term fiscal policy target. To meet this target, general government net lending is to show a surplus of 1 per cent of GDP over a business cycle. There is, however, a fundamental lack of clarity on what this target actually means since completely different indicators are used to evaluate whether the target has been met. Previously these three indicators were used: average net lending since 2000 (this was the first year that the surplus target was fully implemented), a moving seven-year average for net lending (comprising the three previous years, the current year and forecasts for the coming three years) and structural (cyclically adjusted) net lending for the current year. In the 2009 Spring Fiscal Policy Bill, two additional indicators were introduced: an average for structural net lending since 2000 and a moving seven-year average for structural net lending.

Thus there are now *five* different indicators for net lending over a business cycle. Since they measure completely different things and may show different values, there is obviously no clear definition of what the surplus target means. This implies that it is also not clear when there are deviations from the target. This creates unnecessary uncertainty about the future course of fiscal policy. This is unfortunate, particularly in the current situation when the budget deficit is growing. There is therefore a great need for the Government to clarify what the surplus target actually means.

Pre-funding or working longer?

A more fundamental problem is that the motives behind the surplus target are inadequately defined. The underlying assumption is that with an ageing population, demographic developments will put pressure on future public finances. Under the current fiscal policy strategy, this is to be precluded by *pre-funding* in the general government sector in order to accumulate wealth that we can then consume. But pre-funding is not the only strategy available. One alternative is an *adjustment strategy* according to which *working time over the life cycle increases* as longevity increases. There is a strong distribution argument in favour of including increased lifetime working hours in a strategy for a sustainable fiscal policy: since a longer life expectancy is a welfare gain for future generations, longer lifetime working hours contribute more to welfare smoothing between generations than pre-funding does. A major shortcoming in the current fiscal framework is that the surplus target was originally established without any explicit consideration of alternative strategies.

A related problem is that the Government has never defined how long the surplus target is to remain in force. In earlier government bills on the economy, it was assumed that the surplus in general government finances would gradually decline until the middle of the 2020s when the surplus would change to a deficit of 1-1.5 per cent of GDP, at which time the general government sector would begin to use the accumulated assets. The 2009 Budget Bill also opened the door for a future downward revision of the surplus target in connection with the review of the fiscal framework now under way. However, there was no mention of this in the Spring Fiscal Policy Bill, where estimates of sustainability instead assume a return to a surplus of around 1 per cent of GDP once the current recession is over.

One fundamental problem is that the fiscal policy and employment policy frameworks are not sufficiently integrated. In fact, the pre-funding requirement and the future growth of lifetime working hours are interdependent. It is therefore not logical to set a target for general government net lending without at the same time setting a target for how much we are to work in the future. But no such link exists today. On the contrary, in the employment policy framework, which has just come into use, the Government has relinquished quantitative employment targets. This is ill-advised since the quantitative surplus target presupposes an implicit quantitative employment target. There is thus reason for a clear formulation of such a target. This would best be accomplished by specifying a target for how the total number of hours worked per capita should grow over time.

Integrating the fiscal and employment policy frameworks

The Government's ongoing review of the fiscal policy framework should lead to its integration with the employment policy framework so that pre-funding and how much we should work in the future can be weighed against each other. Our report includes an outline of our ideas on how this could be done. This is only a rough illustration, not a finished proposal.

The choice of the appropriate level of net lending should be based on calculations of the long-term sustainability of fiscal policy. It is not sufficient to justify continuing the surplus target of one per cent of GDP by the fact that this was the previous target (since the original target has never been satisfactorily explained). The sustainability of fiscal policy is usually measured as the requirement for annual permanent budget strengthening or budget weakening needed to allow the general government sector to meets its commitments in the long run (the S2 indicator). If rational considerations are to be made, this indicator should be estimated using various assumptions about future lifetime working hours. This would make it clear that it is a question of a *policy choice* of what combination of pre-funding and lifetime working hours is desirable. This could then be turned into a *fiscal balance target* for general government sector net lending and an *employment target*.

In the 2009 Spring Fiscal Policy Bill, the Government for the first time discussed an alternative estimate of sustainability where the labour market exit age increases as life expectancy increases. This may be seen as an embryo of the analysis we would like to see, but it should not, as now, play a marginal role in the Government's considerations. Instead it should be pivotal.

Raising the labour market exit age may be seen as a natural part of a strategy for managing a gradual increase in longevity. The more ambitious the employment target is, the less ambitious the balance target for general government net lending obviously needs to be. The exit age will likely rise even without any changes in the pension system since the last pension reform is still gradually being phased in. We have made some rather rough calculations that indicate that the gradual impact of the pension reform could raise the average exit age from about 63 years to possibly about 64 ½ years by the mid-2020s.

It would, however, be a perilous strategy to give up saving based on a general hope that future generations will work more. It is a strong argument for a rules system that would automatically link the labour market exit age to the increase in longevity since this employment margin is probably both the most important and the easiest to regulate. Such an automatic link of the pension age to life expectancy has been introduced in Denmark. However, in Sweden there is no longer any formal retirement age. In our system, several parameters in the old-age pension system would instead have to be linked to life expectancy: the lowest age for drawing an old-age pension (now 61 years), the mandatory retirement age (now 67 years) and the age at which the right to other social insurance benefits ceases (now 65 years). With such a link, the current budget target for general government net lending could possibly be lowered.

A rational framework for sustainable general government finances should integrate decisions on the fiscal balance target and future pension provisions, making it possible to weigh different objectives against each other in a transparent way. This can be done in many ways – including not allowing lifetime working hours to increase in line with life expectancy if a political majority were to decide so – but it is in any event desirable that the consequences of various policy combinations are made clear.

It is also desirable that the review of the fiscal framework clearly defines the exact time period in which the balance target is to apply. The target could, for example, be set for a ten-year period. The Government could then be obliged to present a plan on how major deviations from the target during this ten-year period are to be handled. At the end of each such ten-year period, both the fiscal balance target and the employment target would be reviewed. This review would then be based both on the previous actual development of general government finances and on how the number of hours worked had developed.

Shorten study time

Yet another way of increasing lifetime working hours is by early labour market entry. This could be achieved if young people began their post-secondary education sooner after finishing upper secondary school and if they interrupted their studies less. One reason that studies commence so late and there are so many interruptions in Sweden is probably the incentives created by the tax and transfer systems. The private costs of postponing one's post-secondary education are much lower than the social costs due to the progressivity in tax and benefit systems.

Some of the Government's labour market reforms have created incentives for university students to postpone their studies. For example, the earned income tax credit also gives students an incentive to work more and thus may reduce the time devoted to studies. The sharp reduction in social contributions for young people creates more room for wage increases and in the long run may be expected to lead to higher wages for young people. It strengthens the incentives for students to postpone their university studies and to supplement their finances with earned income during the study time.

Economic policy measures aimed at increasing the incentives to work are duly justified from an employment perspective, even though they may as a side-effect lure students away from their studies. The student support system should, however, be designed to mitigate this effect as much as possible.

Limiting the number of years that study support may be collected would in all likelihood reduce the average study time. Furthermore, a *lowering* of the exempt amount, i.e. a reduction in the income a student is allowed to have without limiting study support, would reduce students' propensity to work while they study. Since the social return on avoiding long study times exceed the private return, the exempt amount, in our view, should be lowered and not raised as recently proposed by the Student Welfare Inquiry (Studiesociala utredningen). To encourage students to begin their post-secondary studies soon after completing upper secondary school, study support should be made more generous the younger the university students are. This could be done, for example, by making the grant part higher for younger than for older students.

So that students will not choose to work more than necessary during their study time, study support should be at a level at which they can manage on their own without parallel incomes. Since it is the remuneration when studying in relation to the remuneration when working that is key to students' propensity to work, the relative remuneration for studying should not be too low.

Brickbats and bouquets for the Government's tax reductions

One of the Government's most important objectives is a permanent increase in employment. To achieve this goal, a large number of tax policy changes have been implemented. With the aim of strengthening the incentives to work, an earned-income tax credit was introduced at the beginning of 2007 and strengthened one year later. A further strengthening of this tax credit was introduced on 1 January 2009, at the same time that the income threshold for central government income tax was raised. Social contributions were lowered by 1 per cent at the same time.

We were very positive to the earned-income tax credit in our previous report. According to our analysis, it should reduce unemployment and increase employment markedly over the business cycle. The higher income threshold for the central government income tax is probably also an effective method of increasing the number of hours worked. A tax cut of this kind increases the marginal return on work for many people without the need for total tax revenue to fall so much.

However, we are critical of the general cut in social contributions. At best, it yields a marginal increase in labour force participation, and thereby long-term employment, because the wage level can be expected to increase in the long run. A permanent reduction in the social fees is a much costlier method of increasing the number of hours worked than, for example, raising the threshold for the central government income tax.

One reason for the general reduction in social contributions presented in the 2009 Budget Bill is that in the short term, it stimulates the demand for labour when the cyclical situation deteriorates. There are, however, other grounds for questioning a reduction in contributions for cyclical reasons. One obvious question is why this reduction, justified on cyclical grounds, is to be permanent rather than temporary. This has not been explained by the Government. There is, however, an argument that short-term effects on employment are only realised if the reduction is permanent. But if the reduction actually becomes permanent, it is a costly form of stabilisation policy since tax revenues will then also be permanently lower.

The decisions on the tax cuts for 2009 were made in an economic situation that has now completely changed. At that time, we thought we faced a moderate economic slowdown and not, as we know today, an exceptionally deep recession. Several of the proposed reforms were well warranted for long-term efficiency reasons. It is questionable, however, if these tax reductions would have been chosen if the Government had been able to predict the sharp economic downturn. It can be argued that it would have been more appropriate to cut taxes that focus more on groups with low incomes and hence a high propensity to consume. However, it would be unfair to criticise the Government for this since the depth of the economic crisis was impossible to predict. At least no other analysts – including ourselves – managed to predict it either.