Comments on the 2010 Budget Bill
The Swedish Fiscal Policy Council is a government agency. Its remit is to conduct an independent evaluation of the Swedish Government’s fiscal policy. The Council fulfils its tasks primarily through the publication of the report *Swedish Fiscal Policy*, which is presented to the Government once a year. The report is used by the Riksdag as a basis for its evaluation of the Government’s policy. The Council also arranges public conferences and seminars. In the series *Studier i finanspolitik (Studies in Fiscal Policy)*, it publishes in-depth studies of different aspects of fiscal policy.
Foreword

The main task of the Fiscal Policy Council is to produce an annual report evaluating the Government's fiscal and other economic policy. The Council should also “try to stimulate more public debate on economic policy”. The report is published in May each year immediately after the presentation of the Government's Spring Fiscal Policy Bill. This means that a relatively long time has elapsed since the last Budget Bill was presented. In a situation like the current one with a serious economic crisis and major changes in fiscal policy, it may therefore be useful for the Fiscal Policy Council to express its views in connection with the Budget Bill. Hence, we present these comments, which all the members of the Council endorse.

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Summary

- It is the Fiscal Policy Council’s opinion that the size of the additional fiscal stimulus measures announced in the 2010 Budget Bill is reasonable.

- However, the large proportion of unfinanced, permanent reforms poses risks.

- A fourth step in the earned income tax credit may be assumed to yield positive employment effects in the long run. But the Government’s explanation of the workings of the earned income tax credit leaves much to be desired.

- We are critical of the Government’s circumvention of the intentions behind the expenditure ceiling by once again allocating expenditures for 2010 to 2009. This undermines the credibility of the expenditure ceiling.

- We welcome the announced inquiry into a local government stabilisation fund. Smoothing local government income over the business cycle is important if the automatic stabilisers in fiscal policy are to function properly.

- The need to clarify what the surplus target means, which we pointed out in previous reports, remains unchanged.

- The Budget Bill’s presentation of certain reforms as ‘structurally justified’ is misleading. Instead, possible conflicts between the employment and the income distribution policy objectives should be clearly presented as such.

- The criticism we previously directed at the budget bills’ reporting of labour market programmes, the public sector’s total net worth position, public sector capital stock and investments, and central government guarantee commitments is still valid. These deficiencies should be easy to rectify and we are surprised that this has not been done.
Comments on the 2010 Budget Bill

These comments on the 2010 Budget Bill address the general stance of fiscal policy, the balance between different stimulus measures and the expanded earned income tax credit. There is also a discussion of the handling of the expenditure ceiling and the current review of the fiscal framework. Lastly, there are also comments on the motives for policy given in the Budget Bill and on the reporting on certain points. We will come back with an in-depth analysis of these and other issues in our annual report in 2010.

General stance of fiscal policy

The Budget Bill contains proposals for unfinanced expenditure increases and tax reductions of about SEK 32 billion for 2010. According to the Government's own estimates, general government structural (cyclically adjusted) net lending will decline by 1.2 per cent of GDP next year. With the decline in general government net lending, fiscal policy will be more expansive. This is to a large extent motivated by the need for further stimulus measures in the weak cyclical situation. In our opinion, stimulus measures in the Budget Bill are at a reasonable level. This conclusion is based both on an assessment that resource utilisation in the economy will be so low that there is a need for further stimulus measures and on the opinion that the public finances are sufficiently strong that there is room for such stimulus measures. The existence of a credible fiscal framework and Sweden's good 'track record' from its earlier consolidation of its public finances in the 1990s also gives fiscal policy more room for manoeuvre.

The Government's assessment of the appropriate fiscal policy stance now appears to be approximately the same as the Council's in its report in the spring. The reasons cited for the change in the Government's view are reduced uncertainty about future public finances (now that cyclical developments seem to be better than expected earlier and the risk of costly state interventions in the financial markets appears to have lessened) and a better budget outcome than that forecast in the Spring Fiscal Policy Bill. It is not, however, particularly clear in the Budget Bill why these changes are thought to justify a policy that is more expansive than what the Government previously considered appropriate.

In the Council's opinion, stronger stimulus measures should have been deployed already this year. It would at least have been an advantage if the additional stimulus measures for 2010 – particularly the state grants to local governments – had been announced earlier, since expectations of such increases would presumably have had some effect on aggregate demand already in 2009. Given the earlier fiscal policy stance chosen by the Government, however, the extent of the fiscal stimulus for 2010 appears to be

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2 To the extent that the better development of public finances is, for example, due to reduced costs for sickness benefits and sickness insurance, fiscal policy has become less expansive than intended, which may justify additional stimulus measures. But if the public finances have instead developed better than expected because the cyclical situation has deteriorated less than expected, then there is less need for stimulus measures.
well in line with the information currently available. There should, nevertheless, be a high level of preparedness to tighten both monetary and fiscal policy if the economy turns upwards more rapidly than now appears likely.

**Balance between different stimulus measures**

One risk posed by fiscal stimulus measures in an economic downturn is that they give rise to a permanent budget weakening. Moreover, if the measures remain in effect too long after the start of an economic upturn, they may intensify a subsequent overheating. These are strong arguments for stimulus measures to be mostly temporary.

Some of the measures proposed are of this kind. This is particularly true of the additional increase of SEK 10 billion in the local government grants for 2010. We share the Government's opinion that this may be assumed to be an effective measure for maintaining demand and employment. We also welcome the general form of the support being given to local government without any attempt to steer more resources to individual municipalities with bigger financial problems than others: any such selective support policy – over and above the redistributions that occur automatically in the local government equalisation system – would in the long run risk weakening local governments’ accountability for their own finances.

Most of the Government's new initiatives in the Budget Bill, however, entail a permanent budget weakening (about SEK 20 billion of SEK 32 billion for 2010). The most important measures of this kind are an expanded earned income tax credit (SEK 10 billion), a higher non-taxable allowance for people over 65 (SEK 3.5 billion) and increased resources for the judicial system (SEK 2.6 billion). Even if the long-term net cost for the expanded earned income tax credit will be lower because it is expected to increase employment in the long run (see the next section), this permanent budget weakening poses a risk. This is primarily due to the even greater than usual uncertainty about general government structural net lending in the current situation with low resource utilisation. One reason is that the estimates of the structural net lending may not have made sufficient allowance for tax revenue at the end of the economic upturn being inflated by above-normal profits in the financial sector and extraordinary capital gains. Another reason is the uncertainty about the extent to which the current recession may have permanent effects on potential GDP as a consequence of lower investment and permanently lower employment.

The Government has previously argued strongly against temporary fiscal stimulus measures on the grounds that they easily become permanent. A similar argument is to be found in the Budget Bill. Against this background, it is not entirely easy to understand the sizeable permanent, unfinanced reforms in the Budget Bill. The risk that measures announced as permanent will actually become permanent must in all likelihood be considerably higher than for measures announced as temporary.

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3 It is, for example, said that “the Government’s premise is therefore that large expenditure increases, which are intended to be temporary, but which have historically proven difficult to revoke, should be avoided” (p. 35).
The Budget Bill discusses the future fiscal problems that may result from the measures now being taken. The Bill stresses that “general government net lending will gradually revert to a surplus in line with the surplus target” and that “budget reinforcements may need to be made at a later date when the business cycle improves” (p. 24). The proposal to lower the expenditure ceiling for 2012 by SEK 10 billion compared to what was announced in the Spring Fiscal Policy Bill aims at increasing credibility in future budget discipline. As to the fourth step in the earned income tax credit, it also says that it “may, if required at a later date, be financed by increasing other less distortionary taxes” (p. 26). These are of course laudable ambitions, but unfortunately it is always more difficult to actually implement such measures than to hold out the prospect of doing so. The credibility of future budget improvements would increase if these were already clearly defined now.

A fourth step in the earned income tax credit

An expansion of the earned income tax credit is a key proposal in the Budget Bill. In our two annual reports, we have analysed the previous earned income tax credits and at that time shared the Government’s opinion that the earned income tax credit is an effective method of increasing employment in the long run. Experience with the earned income tax credit, particularly in the United States and Great Britain, is positive: a number of evaluations indicate that such tax reductions are effective. There is also macroeconomic research that can be interpreted to mean that the earned income tax credit may reduce the risk that a temporary economic downturn will lead to persistently higher unemployment.

The Government’s explanation of the mechanisms by which the earned income tax credit may be expected to increase employment in the long run leaves much to be desired, however. The explanation given in the Budget Bill is that “strengthening the in-work tax credit contributes to maintaining labour force participation, improving wage formation and increasing mobility in the labour market” and that “this aids a strong increase in employment in the next economic upturn” (p. 45). The explanation for the positive employment effects in the short run is that the expanded earned income tax credit “increases household disposable income, thus stimulating consumption” (p. 45).

The Budget Bill’s discussion of the earned income tax credit is probably difficult for many readers to follow. There may therefore be grounds for developing economic theory’s interpretation of the relationship between the earned income tax credit and the labour market situation.

The usual idea is that there is an equilibrium employment rate that can be achieved in normal economic times and at which inflation can be kept stable. Equilibrium employment is determined by the way in which the labour market functions but it is not directly affected by how high demand is. Fluctuations in demand over the business cycle therefore lead primarily to fluctuations in actual employment around the equilibrium level.

In an analysis of the employment effects of the earned income tax credit, it is thus necessary to differentiate between the short and the long run. The
short-term effects are chiefly the result of fluctuations in demand. One could argue that other types of stimulus measures may have even greater demand effects, since the earned income tax credit also goes to people with high earned incomes who may have a low marginal propensity to consume. But on the other hand, making the earned income tax credit permanent leads to a bigger impact on private consumption than would a temporary tax reduction or benefit increase.5

The long-term effect of the earned income tax credit is due to its effect on equilibrium employment. One mechanism is that the unemployed and other non-employed may be expected to look for a job more intensively if it becomes more profitable to work relative to benefit dependency. This may help improve matching between jobseekers and job vacancies. But in all likelihood the most important effect is that wages in the long run will be lower than otherwise.6 This may be due both to a reduction in an individual’s reservation wage (the lowest wage at which one would be prepared to accept a job) and to lower trade-union wage demands if the employed get more disposable income via a tax reduction. The probable outcome is that the before-tax wage will be lower than would otherwise have been the case, while the after-tax wage will be higher. The higher after-tax wage is likely to increase labour force participation. The lower before-tax wage implies lower wage costs for both the business sector and the public sector, thus making it both profitable and possible to hire more people.

Most economists agree on the mechanisms described. However, it is more difficult to estimate exactly how great the long-term effects may be and how long it will take for them to appear. This is particularly difficult in a situation like the current one with very low demand. In such a situation, it may also be expected that some of the unemployment attributable to the lack of demand may gradually become persistent, structural unemployment.7 An earned income tax credit is likely to counteract such a development.

It may be tempting, based on the decline in employment now taking place, to draw the conclusion that the Government’s labour market reforms have been ineffective. This is hardly a reasonable conclusion, however. The falling employment is due to the sharply reduced demand in the economic downturn which makes it impossible to discern the policy’s effects on equilibrium unemployment. In 2007-08, the problem was the opposite: the then sharply rising employment was primarily due to increased demand during the economic boom, not to the Government’s earned income tax credit and other labour market reforms.8

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5 This argument assumes that households expect the earned income tax credit to be financed by a permanent reduction in public consumption.
6 Economists often express this carelessly, saying that an earned income tax credit results in wage cuts. But it is unlikely that the nominal wage level would fall. The probable course of events is instead that for a few years, wages would increase more slowly than they would have otherwise.
7 The hypothesis is thus that a demand-driven decrease in employment with some time lag also leads to a fall in equilibrium employment. It may be due to negative motivation and health effects on the unemployed, to the fact that they lose human capital and become less attractive in employers’ eyes, and to trade unions which primarily base their wage demands on the interests of those already employed (insiders), not on the labour force as a whole.
8 See Report of the Fiscal Policy Council 2008, Section 9. According to a diagram in recent reports by the National Institute of Economic Research (see, for example, diagram 139 in The Swedish Economy, August 2009) the equilibrium rate of unemployment has been rising since the beginning of 2007. The Social Democrats’ budget motion for 2010 refers to this rise. This conclusion is contrary to the National Institute of Economic Research’s previous assessments of both the Government’s labour market reforms and the wage increases in 2007-2009. As we understand
One relevant question is whether it would be more effective from the point of view of employment to increase public consumption instead of reducing the tax on labour. This is probably the case in the short run, since public consumption is usually assumed to have a higher multiplier effect than tax cuts will.\footnote{The conclusions in the empirical research, however, vary considerably. See Report of the Fiscal Policy Council 2008, Section 1.3.1 and (2009), pp. 61-64.} But in the long run there is little reason to believe that higher public consumption would lead to higher employment. Employment in the long run is determined by equilibrium employment, which in turn, depends primarily on the way in which the labour market functions. There is no research supporting that higher public employment leads to higher equilibrium employment. The probable effect in the long run is instead that permanently higher public employment will lead to wage increases that cause employment in the business sector to be displaced.

**Labour market and education policy measures**

Next year, a substantial part of the labour force – more than five per cent – will participate in new start jobs and various labour market programmes. The aim of the programmes is to reduce the risk of exclusion from the labour market and thus to maintain labour force participation, which is vitally important for employment in the long run.

Experience with large labour market programmes during the 1990s crisis was relatively poor. Labour market training in particular yielded poor results for the participants. Some types of subsidised employment increased participants' chances of finding a job but at the same time contributed to considerable displacement of regular jobs.

There are some indications that labour market programmes should function better now. The benefit levels are lower, particularly for the long-term unemployed, thus reducing the risk of locking-in effects. Programmes can no longer be used to requalify for unemployment insurance. This strengthens the incentives to actually use the programmes to increase participants' chances of finding employment. Job search activities, which appear to be a relatively cost-effective measure, play a bigger role.

At the same time, it is obvious that labour market policy faces major problems. Job search activities and coaching cannot achieve so much if there is a lack of demand for labour. In our 2009 report, we criticised the Spring Fiscal Policy Bill for putting too much faith in what such activities could accomplish in a deep recession. These activities are more likely to function better in an economic upturn.

The labour market initiatives proposed in the Budget Bill are more balanced than previous initiatives. A core part is the initiative Lyftet (‘the Boost’), which involves activation measures pertaining to the “environment, forest conservation, cultural heritage, social services and schools” in the public sector or certain non-profit organisations. To increase the programme volume, it is probably necessary to involve the public sector. At the same time, these
measures will face problems similar to those encountered in the ALU work placement scheme in the 1990s: the difficulty of finding meaningful activities that improve individuals' job chances without these activities displacing regular employment.

Labour market training is still at a historically low level: currently (in September 2009) a monthly average of around 5,000 places. The Budget Bill announced only a marginal increase of 1,000 places next year. Here the criticism in the Council's spring report that the volume is far too low is still valid.\(^\text{10}\) It appears that the Government has overreacted to the poor experience from the 1990s when circumstances were completely different. Evaluations in recent years have shown good results. Keeping labour market training at a substantially lower level than in the 1990s is well justified, but it is difficult to understand the motives for a volume as low as it is now.

One cause for concern is the many new features and improvisations found in labour market policy in the prevailing situation. Not least, it will be a very difficult task for the Swedish Public Employment Service to launch a new labour market introduction programme for people leaving sickness insurance at the same time that very large cyclically dependent programmes are to be administered.

The labour market policy initiatives are combined with temporary increases in the number of places in the regular education system (university and colleges, vocational colleges and adult vocational training/adult education system) in 2010 and 2011. There are in principle good reasons for expanding the regular education system in an economic downturn when the opportunity cost of studying is low. This presupposes, however, that the volume of education can actually be reduced when the business cycle turns upwards. The Budget Bill also notes this, but it contains hardly any analysis of the chances of actually achieving such a reduction and thus avoiding locking-in effects. Another question concerns whether the provisions for adult vocational education, for example (student aid with a higher grant component) are actually sufficiently generous to attract the groups targeted.\(^\text{11}\)

**The expenditure ceiling**

In its spring report, the Council criticised the Government for weakening the credibility of the expenditure ceiling by paying in December 2009 the temporary increase in the local government grants for 2010 it had announced in the Spring Fiscal Policy Bill.\(^\text{12}\) The aim was to reduce the risk of exceeding the expenditure ceiling in 2010. This treatment of the expenditure ceiling is quite similar to the circumventions which took place under previous governments and were criticised by the current Government.

We are very critical of the Government's proposal in the Budget Bill that SEK 6 of the 10 billion in additional temporary local government grants for 2010 will be paid already in 2009. This is justified by “the need to keep a safety margin under the expenditure ceiling” (p. 42). This implies that the Government is once again manipulating the expenditure ceiling contrary to the

\(^{10}\) Report of the Fiscal Policy Council 2009, Section 5.

\(^{11}\) This is discussed in more detail in Report of the Fiscal Policy Council 2009, Sections 5.2.5 and 5.2.8.

\(^{12}\) Report of the Fiscal Policy Council 2009, Section 1.3.2.
intentions behind it. If a correction is made for the estimated budget margin of SEK 17 billion for 2010 for the payments to local governments that will be made this year (SEK 7 + 6 billion), only a margin of about SEK 4 billion remains.

The Budget Bill explicitly discusses the Council's criticism in its spring report that the increased local government grants for 2010 were reported as an expenditure for 2009 (p. 321). The Government admittedly concurs with the basic principle “that expenditures are to be assigned to the right year so as not to make comparability over time more difficult” but then maintains that “if there is a departure from this principle it is to be justified and clearly reported, which was also made in connection with the 2009 Spring Fiscal Policy Bill”. We find this reasoning surprising. It appears that the Government thinks that it is permissible to circumvent the expenditure ceiling if it just explains what it is doing. This argument is contrary to the whole idea behind the expenditure ceiling.

The Government's handling of the expenditure ceiling is of the utmost concern, since a credible ceiling is a key part of the fiscal framework. The attempt to circumvent the expenditure ceiling stands in stark contrast to the Government's otherwise strong emphasis on respecting the expenditure ceiling. This emphasis is reflected in the Government's current proposal to make the three-year expenditure ceiling obligatory. The Budget Act has previously only offered the possibility of setting an expenditure ceiling and has contained provisions on how it is to be used in that event.

The uncertainty about the use of the expenditure ceiling created by such circumventions risks reducing the value of the signal the Government wants to give about future fiscal policy with its downward adjustment of the expenditure ceiling for 2012.

It is our view, as in our report last spring, that the regulatory framework for the expenditure ceiling should be tightened, so that it is no longer possible for the Government to get around it by booking expenditures in a year other than the year to which they refer. Instead, a clear escape clause, which specifies exceptional circumstances under which the ceiling can be temporarily exceeded, or a special cyclical margin that may only be used in economic downturns should be introduced.13

The balanced budget requirement for local governments

The reason why discretionary decisions on temporary increases in grants to local governments were necessary is that the rules system for local government includes a balanced budget requirement, under which local governments must budget for a balance between revenues and costs and compensate within a three-year period for any deficit that might arise. In an economic downturn when the local government tax base shrinks, local governments are therefore compelled to reduce expenditure or raise taxes. In both cases, the automatic stabilisers in fiscal policy, that is to say, the automatic demand stimulus that follows a decline in taxes when revenue falls, are counteracted.

13 A cyclical margin like this is discussed in Report of the Fiscal Policy Council 2008, Section 2.5.5.
Occasional discretionary decisions on how the local government sector is to be supported in economic downturns are ill-advised. The State almost gets into a “blackmail situation” where there is a risk that resource transfers to local governments will be excessive. We therefore welcome the inquiry announced in the Budget Bill to examine how local government sector revenue can be put on a more stable footing over the business cycle. What is said about a local government stabilisation fund is quite vague but we interpret it to mean that central government grants to the entire local government sector are to vary countercyclically, so that they increase more rapidly in economic downturns when the tax base weakens and more slowly in economic upturns when the tax base grows.

The surplus target

The overall target for the public finances is that general government net lending is to show a surplus of one per cent of GDP over the business cycle. We have previously criticised this target for being ill-defined. This is largely due to the use of five different indicators which have completely different meanings and may show different values to evaluate whether the target has been met. It is also due to the failure to state the underlying motives for the surplus target clearly enough.

A review of the fiscal framework is currently under way, which according to the Budget Bill is to be presented before the end of the Government’s term of office. We therefore can appreciate why the shortcomings in monitoring the surplus target have not yet been addressed. But we again want to emphasise the need to clarify what the surplus target means. This is particularly important now that the economic downturn has led to a fiscal deficit.

We also want to draw attention to the fact that the Budget Bill is extremely vague about what the surplus target should be in the future. In one place it states that “general government net lending will gradually revert to a surplus in line with the surplus target” (p. 24). The discussion of the review of the fiscal framework instead indicates that the one per cent target may be adjusted downwards (p. 64). In the fiscal sustainability calculations, the base scenario seems to imply a surplus substantially higher than one per cent of GDP in the future (p. 296).

The motives for policy

The Fiscal Policy Council, according to its remit, is also to review “the basis stated for economic policy and the reasons for proposed measures”. This is not the place for a full analysis, but we nevertheless want to draw attention to the language used by the Government in justifying various reforms. A recurring phrase is that certain measures are 'structurally justified' and should therefore be implemented. For example, the Budget Statement argues for 'structurally justified tax cuts', referring primarily to the earned income tax credit (pp. 35 and 43).

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By this term, the Government means tax cuts that are expected to increase employment in the long run (equilibrium employment). The term 'structurally justified measure' is, however, unfortunate, since it gives the impression that the measure is justified in some objective sense. This, of course, is not the case. Increasing employment is a worthy goal. But at the same time, this objective may conflict with other objectives such as those for income distribution. Whether or not one thinks that an increased income difference between those who have a job and those who do not is an acceptable price for higher employment is purely a matter of values. It is important that these conflicting objectives be presented to the voters in a clear way rather than concealed behind wording saying that certain measures are 'structurally justified' while others are not.

One illustration of the problems involved is in how the Government presents the increase in the non-taxable allowance for people over 65. The Government justifies this increase, saying *inter alia* that it “contributes to greater security” and has “beneficial income distribution effects” (p. 25). From a strictly logical point of view, the increased non-taxable allowance for pensioners could as well have been presented as a 'structurally unjustified measure', since it weakens the incentives for older people to work.

**Reporting in the Budget Bill**

In our annual report, we pointed out a number of areas where reporting in the budget bills is very incomplete and needs improving. However, no changes of the kind we recommended have been made in this Budget Bill. So this criticism of ours still stands. It applies primarily to the following areas:

- **The reporting of the labour market programmes is quite unsatisfactory.** The programme volume, for example, has not been set in relation to the total number of jobseekers, which is an essential step in assessing the policy's level of ambition. Furthermore, new start jobs are not counted as labour market programmes. Above all, it is not possible to get a picture of how all the labour market initiatives are distributed between various programmes and of the activities within the framework of the job and development guarantee.

- **Reporting of the public sector's total net worth position is still inadequate.** There is only a snapshot (the situation at the end of 2008) but no picture of developments over a number of years (p. 279).

- **There is no reporting of how public investment is allocated between different purposes and between various parts of the public sector.** The same criticisms apply to the public sector capital stock. As in the Spring Fiscal Policy Bill, an increase in the public sector capital stock of approximately four per cent of GDP in 2008, which seems to be an unreasonably large increase, is reported without any comment. (p. 280).  

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15 The comment made on deficiencies in reporting public sector capital stock is an assertion “that it is very difficult to estimate the size of the public sector capital stock” (p. 322). Furthermore the Budget Bill stresses that “in the
• We would also have liked to have seen an in-depth analysis of the risks implied in the central government's increased lending activities and various guarantee commitments. A risk analysis of this kind is highly relevant in the situation that has arisen. No such detailed analysis has been made in the Budget Bill.

Our proposals on improving reporting on various points should not have been at all controversial. They should also require very little work to implement. We are therefore surprised that these views have not been taken into account. A positive interpretation may be that the Ministry of Finance has had such a heavy workload in the past year that it simply was unable to deal with reporting issues and instead concentrated all its efforts on analysing the economic situation and various policy proposals. If so, it is to be hoped that there will be more opportunities to improve reporting in time for the Spring Fiscal Policy Bill next year.

Government's view, investment decisions for public investment should preferably be based on social cost-benefit calculations rather than on a measure of optimal aggregate capital stock. The obvious counter argument is that there is no conflict between making social cost-benefit investment calculations and attempting to estimate how large the aggregate capital stock is and whether the latter is larger or smaller than desired. Various types of information should be considered as complements, particularly since cost-benefit calculations are highly uncertain.