

Summary

Despite a deep economic downturn, there were only small budget deficits in Sweden. Now a strong economic upturn with increasing employment is under way. The public finances are improving rapidly. The Government has revised its estimate of the scope for tax reductions and expenditure increases upwards. There are good grounds for this. At the same time, weaknesses in the economic policy decision-making process and the institutional framework may lead to increased tensions over time and thus threaten long-term stability. Such warnings may be perceived as irrelevant in the current situation. But events in other countries demonstrate the importance of identifying and preventing potential problems in good times.

As in previous years, the main emphasis of the report is on the public finances and the labour market. The report also discusses identification of business cycles, financial stability, taxes and education.

Strong public finances in Sweden

The financial crisis that started in the United States in 2007 culminated in a deep international recession. The combination of a financial crisis and a deep economic downturn put great pressure on public finances internationally. Budget deficits climbed to around ten per cent of GDP in many countries such as the United Kingdom and the United States, which were forced to rescue their financial sectors with extensive government support and experienced sharply reduced tax revenues and increased expenditures. Large increases in the budget deficits in some euro area countries precipitated sovereign debt crises.

Sweden weathered the economic crisis with remarkably good public finances. Budget deficits were only 0.9 and 0.3 per cent of GDP in 2009 and 2010 respectively. The small deficits were largely due to the stronger public finances in Sweden than in most other countries at the outset of the crisis. But the deterioration in Swedish public finances during the economic downturn was also surprisingly small. GDP fell more in Sweden than in the OECD as a whole, but government net lending fell much less.

One of the main reasons why the public finances did not weaken more was the relatively small decline in employment compared with the substantial fall in GDP. This maintained tax revenue. Reduced state funding of unemployment insurance and lower benefit levels helped prevent unemployment expenditure from increasing sharply when employment fell. At the same time, the sickness insurance reforms led to a reduction in the number of benefit recipients in sickness insurance and early retirement. The labour market reforms implemented probably also contributed to preventing the fall in employment.

Better estimates of structural net lending are needed

The most important instrument for steering fiscal policy is the *surplus target*. Under this target, general government net lending is to be one per cent over a business cycle. As it is difficult to determine the precise length of a business cycle, the Government uses a number of indicators (five in all) to evaluate whether the target has been achieved: both backward- and forward-looking averages are considered and adjustments are made to take the cyclical situation into account. We are – as we were previously – critical of the large number of indicators that provide opportunities for arbitrary interpretations. We instead recommend that only two indicators be used: a backward-looking ten-year average (of actual net lending) and a partially forward-looking ten-year average (of actual net lending for the past six years and forecast net lending for the current and the coming three years).

The indicator that the Government appears to attach the greatest importance to is *structural net lending*. It is an estimate of what the fiscal balance would be in a balanced state of the business cycle. The estimate adjusts actual net lending for the *automatic stabilisers*, i.e. the fluctuations in tax revenue and public expenditure that automatically occur (in the absence of discretionary measures) in the course of cyclical swings. The cyclical situation is measured by the *GDP gap*, which shows how much actual GDP deviates from potential GDP.

In the 2011 Budget Bill and the 2011 Spring Fiscal Policy Bill, the Government bases fiscal policy on a forecast for structural net lending. There are a number of problems with this indicator.

- The estimates of the GDP gap on which the estimates of structural net lending are based are highly uncertain.
- With the methods used by the Ministry of Finance, the average GDP gap is negative, i.e. GDP is below its potential level. *Asymmetric* GDP gaps like this are justified if potential GDP is defined as the GDP level that is compatible with a constant rate of inflation. Since inflation is more flexible upwards than downwards, the Riksbank (the Swedish central bank) must pursue a monetary policy that results in a negative average GDP gap if inflation is to be held stable around the inflation target. But a GDP gap defined in this way is not appropriate for estimating a structural net lending that will act as an indicator of whether the surplus target is met, as an average measure will be needed in that case.
- A third problem concerns the Ministry of Finance estimate of the sensitivity of net lending to changes in the GDP gap. The Ministry (and OECD) estimate does not take into account the *balanced budget requirement for local governments*, under which local governments are not allowed to have budget deficits. In the event of a sharp and/or protracted fall in GDP, local government expenditures must be brought in line with lower tax revenues. This is not taken into consideration in the calculations. Consequently, both the automatic stabilisers and structural net lending are overestimated in deep economic downturns.

Relying as heavily as the Government does on structural net lending as an indicator of whether the surplus target has been met is ill-advised. There are in any case grounds for a review of how the estimates are made. Methods involving a negative average GDP gap should not be used.

In the 2011 Budget Bill, the Government set the structural net lending target for 2014 at *two* per cent of GDP. This created uncertainty about whether the surplus target had been raised. Furthermore, the Government did not offer a satisfactory explanation of the extent to which the safety margin of one per cent of GDP required for structural net lending in relation to the surplus target depended on asymmetric GDP gaps (which can be avoided with a more appropriate method of calculation), general uncertainty about future developments (which instead should be reflected in the

level of the surplus target) or uncertainty in the estimate of structural net lending. The same flaw is repeated in the 2011 Spring Fiscal Policy Bill. It states that there is now less need for a safety margin but it does not specify how much less.

The Government has appointed an inquiry on the balanced budget requirement for local governments. One of its tasks is to analyse giving local governments more freedom to vary their budget outcomes from year to year. Another task is to investigate the possibility of establishing a *local government stabilisation fund* where local governments make deposits in economic upturns that can subsequently be used in economic downturns. We are surprised that the inquiry was *not* also asked to investigate a rules system that would allow *central government grants* to local government to vary over the business cycle. This appears to be the simplest system to introduce since it is effective and poses no risk of conflict with local self-government.

Explaining the scope for reform more clearly

The *scope for reform* plays a key role in fiscal policy. It is of great value that the fiscal policy debate be based on an explicit estimate of “what we can afford”. In the same vein, it is remarkable that the budget bills do not provide a brief definition of the concept scope for reform, even though the meaning can be inferred from the discussion as a whole. The scope for reform can be defined as:

The total sum of permanent tax reductions and expenditure increases that can be actively decided by the Riksdag (the Swedish Parliament) and that are compatible with the target that general government net lending should show a surplus of one per cent of GDP over a business cycle.

The term ‘scope for reform’ is actually misleading, as some reforms do not cost anything or even strengthen the budget (as did the earlier reforms of unemployment and sickness insurance). Reforms costing more than the scope for reform allows may also be made if they are financed by tax increases (for expenditure increases) or by expenditure reductions (for tax cuts). *Fiscal space* is a better term than scope for reform. But we use the term scope for reform below so

that readers will recognise it, even though the term should be replaced.

The Budget Bills do not provide a clear explanation of why there normally is scope for reform. The explanation is as follows. As most taxes are proportional, tax revenue automatically grows at approximately the same pace as GDP. But without active decisions, public expenditure grows more slowly than GDP. This is because only some expenditures are tied to wages (which in the long run grow at the same pace as GDP). Other expenditures are only partly indexed to wages or are indexed to prices (which increase more slowly than GDP in current prices). Some expenditures are not indexed at all and therefore fall in real terms when prices rise.

Without active decisions on new 'reforms', net lending would gradually increase relative to the surplus target. Some of the scope for reform, however, originates when 'old reforms', in the absence of new decisions, are diluted when some expenditures fall in real terms and others do not follow wage developments.

A political decision-making process, based on an ever emerging scope for reform, is *politically attractive*. This gives the Government the opportunity each year to present a number of 'reforms', even though these only maintain the value of previous transfer payments. Decisions that only involve maintaining previous reforms may in other words be presented as *new* reforms. If the Government wishes to cut taxes or increase expenditures in new areas, it can be done without *active* decisions to weaken old reforms.

The Government should clearly report how the scope for reform comes about. It should be broken down into contributions from reductions in the real value of public expenditures that are not indexed to prices, from other expenditures that do not follow GDP, from demographic changes, from changes in the number of benefit recipients in different social insurance systems as a result of various changes in the rules and from deviations from the surplus target motivated by the cyclical situation. A report like this would contribute to a more informed debate. It would make it possible for voters to weigh proposed tax cuts and expenditure increases against the financing.

The decision-making system based on estimates of the scope for reform is well suited to gradually reduce taxes and public expenditures as a percentage of GDP. It has appeared natural to

divide the scope for reform between tax reductions and expenditure increases. Since the scope for reform emerges when public expenditure, in the absence of active decisions, does not follow GDP, the result is a gradual decline in taxes and expenditures as proportions of GDP.

But a policy like this can in the long run lead to a build-up of *tensions* that jeopardise budget discipline. A gradual dilution of different transfer payments in relation to the wage and price levels may prove to be politically unsustainable. There may be pressure to restore the replacement rate in various transfer systems to earlier levels. This pressure may be difficult to resist when some of the previously estimated room for reform is used for tax cuts.

Risk of exhausting the scope for reform

In the 2011 Budget Bill, the scope for reform for 2012-2014 was preliminarily estimated at SEK 48 billion (in the sense of a permanent annual cost increase until 2014). For 2012, the preliminary scope for reform given was SEK 15 billion. In the 2011 Spring Fiscal Policy Bill, no new number was specified, but the scope for reform is now expected to be greater than that specified in the 2011 Budget Bill.

When the Spring Fiscal Policy Bill was presented, the Government also presented a number of preliminary tax proposals for 2012 in a special tax memorandum. The most important are a fifth step in the earned income tax credit, a higher threshold for the state income tax, an increase in the basic allowance for people over 65 and an increase in the excise taxes on tobacco and alcohol. The net cost of the tax proposals is about SEK 16 billion. The 2011 Spring Fiscal Policy Bill also raises the possibility of reducing the VAT on restaurant and catering services already in 2012. In addition to these proposals, some expenditure increases are likely. All in all, this indicates that the Government has substantially revised upwards its estimation of the scope for reform for next year.

It is unclear why the Government already in the 2011 Spring Fiscal Policy Bill so explicitly specifies proposals that it intends first to present in the 2012 Budget Bill. The detailed description of planned tax changes has the character of commitments that in practice are likely to oblige the Government to implement the

proposals in 2012. This reduces the possibilities of taking new information into consideration during the work on the budget. It is difficult to see the merit in this.

The more positive estimate of the scope for reform in the 2011 Spring Fiscal Policy Bill than in the 2011 Budget Bill is largely due to a more optimistic view of the effects of the labour market reforms. The Government's opinion is not unreasonable. At the same time, there is considerable uncertainty. There are therefore strong arguments for not using all of the estimated fiscal space before there are clear indications that the labour market has actually improved in line with the Government's expectations.

We share the Government's opinion that fiscal stimulus measures are not needed at present. In our view, there is instead a risk that reforms of the magnitude presented by the Government in the 2011 Spring Fiscal Policy Bill may contribute to too strong an economic upturn. To avoid an overheating, it may prove desirable, with the Government's current measure of structural net lending, to let it increase to substantially more than two per cent of GDP until 2014. It may be a difficult challenge for the political system, in a period of considerable optimism, to refrain from excessively large and costly reforms.

The expenditure ceiling may be too weak

The expenditure ceiling is a core component of the fiscal framework. The ceiling is decided for (at least) three years ahead and refers to all central government expenditures except interest payments. The ceiling set includes a *budget margin*, which provides a safety margin to expenditures already adopted and announced. The margin is intended to provide space for both newly decided and automatic expenditure increases that result from a weaker-than-expected economic cycle as well as for other negative 'surprises'.

According to the Government's guidelines, the budget margin should be 1 per cent of the expenditures subject to the ceiling for the current year (year t), 1.5 per cent for year $t+1$, 2 per cent for year $t+2$ and 3 per cent for year $t+3$. The margins over the next few years are substantially higher than that. The margin in 2012 is 7.4 per cent and then slowly falls to 5.6 per cent by 2014 (decided) and 5.3 per cent in 2015 (announced).

Because of the high budget margins, the expenditure ceiling will be less binding than before. This reflects a change in the Government's earlier view of the expenditure ceiling as a support for the surplus target. The Government's new approach seems instead to be that the surplus target is to be a support for the expenditure ceiling. This change is risky, as the expenditure ceiling is a more binding restriction than the surplus target: under the Budget Act, the Government is obliged to propose measures for keeping expenditures under the ceiling, should there be a threat that it will be exceeded.

The Government's budget policy discipline currently enjoys a high level of credibility. But it should not be assumed that the current situation will necessarily continue. It is well known that conflicts between desired tax cuts and desired expenditure increases can be particularly difficult to resist for coalition and minority governments.

The budget margin for 2014 announced in the Spring Fiscal Policy Bill is almost SEK 60 billion. The Government has announced tax cuts for 2012 of more than SEK 20 billion (if the announced tax reduction on restaurant and catering services is included). Assume that further tax reductions of SEK 10-20 billion are carried out during the current mandate. Moreover, if the entire budget margin were to be used, there would be a budget weakening of SEK 90-100 billion. This sharply exceeds the estimated scope for reform of 'somewhat more' than SEK 48 billion.

The above figures are not a forecast. But there is a risk that *both* large tax cuts *and* large expenditure increases may be carried out. Even though there is currently a strong political will to avoid this, and therefore such a development appears less probable, systems should be constructed to minimise this risk.

We do not take any position on the balance to be struck between taxes and public expenditures. But we think there are strong arguments for a downward revision of the expenditure ceiling if the Government carries out the announced tax cuts. If the Government wishes to maintain the current budget margin, the large tax cuts promised should not be implemented.

One argument for large budget margins is that they provide room for substantial expenditure increases in the event that the economic cycle develops less favourably than expected. A better way of handling this is, as we previously have proposed, to distinguish

between a *cyclical margin* (that can only be used for cyclically justified expenditure increases) and a *planning margin* (for other expenditure increases). The latter could then be set much narrower than the current budget margin. An alternative would be instead to introduce a well-defined *escape clause* that allows the expenditure ceiling to be exceeded in extreme situations. In this alternative, the budget margin can also be reduced. We recommend implementing one of these proposals. An economic upturn presents an excellent opportunity for such a change.

Inadequate reporting of public investment

A frequent objection to the surplus target is that the Government should not continue to reduce its debt when it has now come down to a low level. This objection is often based on a misunderstanding.

At the end of 2010, the public sector had a *net financial worth* of more than 20 per cent of GDP. With positive net lending, net financial worth in crowns will keep increasing. But this is not true of net worth as a percentage of GDP. If GDP in current prices increases at an average of five per cent a year (two per cent inflation and three per cent real growth), net financial worth, given an average net lending of one per cent of GDP, will fluctuate just around the current 20 per cent of GDP. The fiscal surpluses are just sufficient to offset the decrease in net financial worth as a percentage of GDP that would otherwise occur when GDP grows.

The Government has justified the sale of state shares by arguing that it wants to reduce the central government debt. But from the standpoint of public finances, this is hardly necessary as the return to its shareholdings is presumably higher than the reduction in the interest on government debt that the revenue from privatisations would be used for.

A further issue is whether the current surplus target, which is based on *net* lending and not on total savings (including investment in capital stock), leads to the neglect of public investments. Existing research does not provide any clear answer here. We have, however, previously pointed to the risk that inadequate reporting of public sector investment and real capital stock in the budget bills provides the Riksdag with a poor basis for decision-making. In the 2010 Spring Fiscal Policy Bill, the Government announced that it intended

to improve this reporting and to include a report of this work in the 2011 Spring Fiscal Policy Bill. But this bill does not contain any information on this matter. We are critical of this. Significant improvements in reporting public sector investment should be possible with little analytical effort.

One way of ensuring that development of the public sector capital stock gets sufficient attention could be via an annual special report from the Government to the Riksdag. At the very least, there should be a special chapter devoted to public investment in either the Spring Fiscal Policy Bill or the Budget Bill.

Business cycle analysis should be improved

There have been few systematic attempts in Sweden to establish more exactly the anatomy of business cycles. A more precise dating of business cycles would be valuable not least if the target that public finances are to show a surplus of one per cent of GDP *over a business cycle* is to be taken seriously. We do not think that more indicators of whether the surplus target has been met should be added to those which already exist (and which are too numerous). But an analysis of net lending during different business cycles can help in evaluating the current indicators.

In this report we apply different methods to date business cycles in Sweden. The dating establishes the turning points in the business cycle, i.e. when the economy shifts from an economic upturn to a downturn and vice versa. The length of a business cycle can be measured either from peak to peak or from trough to trough. The different methods yield quite similar results. All indicate, for example, that the business cycle turned upwards again in one of the first three quarters of 2009. Our analysis also indicates that economic upturns are normally longer than economic downturns.

General government net lending was 1.4 per cent of GDP over the latest complete business cycle if measured from peak to peak (2000-2008) and 1.2 per cent of GDP if measured from trough to trough (2003-2009). During this cycle, the surplus target was thus exceeded. This analysis provides a different result than the backward-looking ten-year average used by the Government, which indicates a net lending of 0.8 per cent of GDP. The discrepancy indicates the importance of having a clear picture of the cyclical situation.

Too few resources devoted to fiscal sustainability analyses

The 2011 Spring Fiscal Policy Bill (like earlier Spring Fiscal Policy Bills) contains estimates of long-term fiscal sustainability. The aim is to judge if it is possible at current tax rates to finance future public commitments when demographic conditions change.

The conclusion in the 2011 Spring Fiscal Policy Bill's base scenario is that the public sector, assuming unchanged rules, will have primary surpluses (the difference between revenue and expenditure excluding interest) for the rest of the century. The surpluses correspond to a permanent, annual surplus of 3.4 per cent of GDP. Sweden thus finds itself in a unique position internationally. Most other economically developed countries face significant fiscal sustainability problems that will force large budget cuts. In Sweden – according to the sustainability calculations – there will instead be room for tax cuts and/or expenditure increases in the future.

The sustainability calculations in the 2011 Spring Fiscal Policy Bill differ radically from previous years' estimates. In the 2010 Spring Fiscal Policy Bill, fiscal policy was expected to be exactly sustainable. The main reason for the change in the sustainability assessment is that price growth for public consumption has been adjusted downwards. This is not the first time that this assessment has been changed. The frequent and inadequately explained changes in such a significant component of the sustainability calculations are a problem. In the 2011 Spring Fiscal Policy Bill, it is impossible to infer exactly what assumptions are behind the change. The inadequate reporting on this point is unsatisfactory.

As in previous Spring Fiscal Policy Bills, there are a number of alternative scenarios analysed in the 2011 Spring Fiscal Policy Bill. These contribute valuable information about how different assumptions affect the analysis. The main conclusion is that the long-term sustainability of the public finances depends on high employment and is very sensitive to the demand for welfare services of higher quality.

According to the Government, achieving an equal distribution of resources between generations is an important argument for the surplus target. But the Government has not defined what it means by equity between successive generations.

We have in all our reports requested clearer analyses of how public finances affect the distribution between different generations –*generational accounts*. We once more wish to underline the need for such analyses. Without generational analyses, it is impossible to assess the surplus target’s impact on intergenerational distribution. Nor is it possible to judge what the consequences of various proposals for tax changes and expenditure increases will be for different generations.

Given the limited resources allocated by the Ministry of Finance for sustainability calculations, the quality of these calculations is high. But these resources are too few. Such an important part of the fiscal estimates should be given higher priority.

A new framework for financial stability

The global financial crisis has yielded a new fundamental insight: *financial stability* should be a more prominent economic policy objective. The serious underestimation by decision-makers in finance ministries and central banks of the systemic risks that developed in the financial sector contributed to the international crisis. The cost of support provided to the financial system has contributed to the sharp deterioration in the public finances in many countries.

Most economically developed countries have now strengthened, or are in the process of strengthening, their *macroprudential frameworks*. Even though the impact on the financial system in Sweden was much milder than in many other countries, there are strong arguments for paying attention to the international lessons about macroprudential supervision.

Financial stability is not a new objective. Three public bodies are currently responsible for financial stability in Sweden: the Riksbank, the Swedish Financial Supervisory Authority and the Ministry of Finance. They are all equipped with different tools to fulfil this objective. Financial stability is one of the Riksbank’s objectives, even though the objective has not been made operational. The Financial Supervisory Authority is responsible for traditional microprudential supervision and regulation. The Ministry of Finance is responsible for legislation and tax issues. The Riksbank, the Financial Supervisory Authority, the Ministry of Finance and the Swedish National Debt Office cooperate on matters that concern financial imbalances. There

is thus already a system in place for managing threats to financial stability.

But the existing system has one major weakness: there is no body with the main responsibility for monitoring the risks of financial imbalances and propose measures when the systemic risks approach a critical level. The division of responsibility between the different bodies is blurred. As macroprudential oversight is not a main task for any of them, there is a risk that none of them will sound the alarm in time.

The framework for financial stability needs to be strengthened. We see two alternatives. The first is to give the *Riksbank* greater responsibility for macroprudential regulation, with an expanded arsenal of instruments, if necessary. The other is to establish a new public authority, a *financial stability council*, with the remit of identifying financial systemic risks and proposing measures.

We see good arguments for both solutions. The arguments for giving the Riksbank main responsibility for financial stability are as follows: Its traditional monetary policy instruments provide it with effective tools for managing the financial markets. Its contact with banks and financial companies is direct and ongoing. It already has a responsibility for financial stability. It has the best analytical capacity with some 70 economists working on the financial sector. It publishes a report on financial stability twice a year.

But there are also objections to giving the Riksbank a broader remit. The Riksbank already has considerable power. There can also be a conflict between the price stability objective and the financial stability objective. The Riksbank's independence currently to a large extent rests on the fact that it has *one* clear main objective: low inflation. Should the Riksbank be given more responsibility for financial stability, it would be more difficult to evaluate how well it achieves its objectives.

The other alternative is to establish a financial stability council with responsibility for macroprudential supervision. In that case, such a council should have the remit to analyse changes in the domestic and international financial systems that might threaten financial stability in the Swedish economy. The council should be obliged to publish its analyses regularly, possibly twice a year. It could address its recommendations to the Riksbank, the Financial Supervisory Authority and the Ministry of Finance as well as to other

public authorities and to banks and financial companies. The recommendations would not be binding. In our opinion, a stability council should not have any policy tools of its own.

There are a number of advantages to this solution. The body created would focus solely on financial systemic risks. A stability council could be more active in warning of financial dangers and more freely propose measures than the Riksbank could. Such a council would provide one more voice in the economic policy debate. Since it would not have any formal regulatory instruments, it would fit into the existing structure well without creating overlapping jurisdictions. A financial stability council could also develop contacts with corresponding institutions recently established in other countries.

The primary objection to a new public authority is that its recommendations do not have to be followed by those institutions having the means at their disposal to influence the financial markets. Not least is the risk that the Riksbank might not feel the same degree of responsibility for macroprudential issues. A financial stability council could be toothless.

We thus see two possibilities. The final choice is not crucial. What is essential here is to strengthen macroprudential supervision. The central problem is to identify risks of financial imbalances in good time. Here current international experience, as well as our own history, proves that existing institutions have lacked the capacity to react in time.

Positive labour market developments

The labour market is now recovering rapidly. In March this year, employment was already higher than before the crisis, but the employment rate was still lower. Labour force participation has held up well during the crisis and is now increasing. This causes unemployment to decline more slowly than it would have otherwise.

Deep economic downturns often have persistent adverse labour market effects. Equilibrium unemployment, the unemployment which is due to the way in which the labour market functions, normally rises. Several mechanisms may contribute to this. Matching supply and demand may be worse if sectors other than those that stagnated during the crisis expand after the crisis. The human capital

of the long-term unemployed may become obsolete, they may seem less attractive to employers and discouraged-worker effects may make job searches less effective. There is also a risk that unions in wage formation will first take their employed members' (*insiders*) interests into account before those of the unemployed (*outsiders*). If so, wage increases in economic upturns may be so high that firms' new hiring is limited.

In our opinion, the long-term effects of the recent crisis will be relatively small. There are several reasons for this. The increase in unemployment and the decrease in employment were limited in relation to the fall in GDP. Adjustment to the cyclical situation in the recent crisis to a greater extent than in the crisis in the early 1990s was accomplished by a reduction in the average hours worked. The increase in labour force participation also reduces the risk of exclusion.

Young people were particularly hard hit by the crisis but are now enjoying rapidly rising employment. Our analysis indicates that unemployed young people have better, not worse, chances of finding a job than unemployed people in general. This is often forgotten. This is one reason why unemployment may be less of a problem for young people than for older people. But young people have a higher unemployment risk than other groups. That youth unemployment increased so much during the crisis was due more to the fact that more young people went from employment to unemployment than to young people having greater difficulty finding a new job. In the economic upturn, unemployment has declined more among young people than among other age groups. Nevertheless, youth unemployment is still high.

Unlike previous crises, employment during the downturn held up better for those born abroad than for those born in Sweden. Unemployment still increased more among the foreign born and kept on increasing in 2010. In 2010 employment also rose more slowly for the foreign born than for those born in Sweden. The employment rate for older workers rose during the crisis. This is a positive development as older workers run a particularly high risk of persistent unemployment.

An analysis of the connection between job vacancies and unemployment shows that matching worsened after the crisis in the early 1990s. When Public Employment Service job vacancy data are

used, there are some signs of another worsening in matching in recent years. When Statistics Sweden data on job vacancies are used, the picture is less clear. Our analysis of how the outflow from unemployment to employment (the job finding rate) depends on the labour market situation does not show any pattern that differs from developments before the crisis. Our overall assessment is that the crisis has not led to any significant worsening of matching in the labour market.

But there are worrying factors. Even before the crisis, there were serious problems with long-term unemployment, particularly among the foreign born, the low-skilled and older workers. The crisis made the situation for these groups of long-term unemployed even worse. The persistently weak labour market situation for people with only a pre-upper secondary education is particularly difficult. Further labour market and education measures may be required. It is also worrisome that unemployment – and long-term unemployment – are still increasing among the foreign born. This group to some extent overlaps with the low-skilled.

Greater transparency about the wage effects of the earned income tax credit

The Spring Fiscal Policy Bill makes an optimistic assessment of the long-term effects of the Government's labour market reforms. They are assumed in the long run to contribute to a 4.6 per cent increase in employment and a 1.4 percentage point decrease in unemployment.

In our opinion, the Ministry of Finance's analysis is well supported by research and competently done. One problem, however, is that entirely different methods are used to assess different effects. Then these sub-results are added together to form an overall assessment. The lack of a uniform analytical model makes it difficult to know whether the different sub-results are consistent with each other. It would have been preferable to use an integrated *general equilibrium model* to analyse all the effects. The Ministry should develop a model of this type.

We have criticised the Government for not satisfactorily explaining that the earned income tax credit and the reduction in unemployment benefits primarily affect employment by restraining wages. In the 2011 Spring Fiscal Policy Bill, the Government for the

first time explicitly states that such wage effects are likely. This is welcome and enables a more nuanced discussion.

According to the Ministry of Finance, the earned income tax credits introduced thus far will in the long run help increase the average *after-tax* wage a full 6.1 per cent, while lowering the *before-tax* wage by only 1.1 per cent (compared to what it would otherwise be). All in all, the Ministry estimates that the decrease in social contributions will increase wages (before tax) by approximately the same amount as the earned income tax credit and lower unemployment benefits reduce them. It is difficult to judge the plausibility of these estimates. Because completely different methods are used to calculate wages and estimate the employment effects, it is impossible to know whether the results are consistent. A background study for our report indicates a significant negative correlation between wages of individuals and the after-tax replacement rate that would be received in case of unemployment. This may indicate that the wage-dampening effects of the earned income tax credit and lower unemployment benefits are considerably greater than the Government's estimate.

The Government's overall assessment of the effects of the labour market policy reforms is not unreasonable. In other countries that have carried out similar reforms, unemployment has declined substantially. At the same time, there is considerable uncertainty. This is true of both the magnitude of the effects and the pace at which they ensue.

It is difficult to judge whether additional earned income tax credits have diminishing returns, i.e. if the effects will decrease as more credits are implemented. Instead, the decisive factor should be how to value the reduction of the *effective* degree of insurance (the after-tax replacement rate) offered to someone who becomes unemployed compared to the value of further reductions in unemployment. This is a political issue. But it is reasonable to think that the perceived disadvantage of further earned income tax credits, in the form of lower effective insurance in the event of unemployment, will rise as the income difference between someone who has a job and someone who is unemployed increases. The perceived value of lower unemployment is likely to decrease the lower unemployment in the long run is expected to be. The

arguments for more earned income tax credits thus quite likely become weaker as more credits are introduced.

Unemployment insurance should be reformed

With the current unemployment insurance system, we see only slight advantages in differentiated individual contributions. Under certain conditions, contributions that are differentiated according to the unemployment in each fund can create incentives for lower wage growth and thus contribute to higher employment. But these conditions are probably not met.

One idea behind the differentiation in contributions is that the members in a particular trade union should have to bear a large part of the cost should they, by high wage demands, cause an increase in unemployment among those participating in the unemployment insurance fund associated with the union. But this connection is quite weak. The differentiated contributions account for – at the margin – $1/3$ of the unemployment costs in a fund at most. According to our calculations, the funds and trade unions only overlap by about $2/3$. This means that the members in a union on average bear at most $(1/3) \times (2/3) = 2/9$ of the unemployment costs in their collective bargaining area. In practice, their share is considerably lower as the long-term unemployed do not get any unemployment benefits from the funds.

The current contribution differentiation is more trouble than it is worth. One major disadvantage is the membership exodus from the unemployment insurance funds. Our conclusion is that the contribution differentiation should be scrapped if the current system of voluntary unemployment insurance funds is retained.

In principle a strong argument can be made for *mandatory* unemployment insurance. A mandatory system satisfies both the paternalistic desire that everyone – even those with a lack of foresight – have an income-related insurance and the desire that everyone (even those at little risk of unemployment) should help finance the insurance. These arguments are in our opinion as strong for unemployment insurance as for other types of social insurance.

There are strong theoretical grounds to explain why decreasing benefits over the unemployment spell provide an appropriate combination of insurance and incentives to find a job quickly. But in

the current system, only a minority of the unemployed face a potential decrease of this kind. One reason is that many are not part of this income-related insurance. Another reason is that the ceiling for the unemployment insurance funds has been nominally unchanged and has therefore fallen sharply relative to the wage level, with the result that an increasing number of those employed exceed the ceiling.

The sitting cross-party inquiry into social insurance should examine all the issues discussed above: contribution differentiation, mandatory insurance, qualification requirements for unemployment benefits and the level of the ceiling in the unemployment insurance funds. Another issue that should be investigated is whether unemployment insurance can be made *cyclically dependent* as in Canada and the United States, so that it is more generous in economic downturns than in economic upturns.

There are two major arguments in favour of cyclically dependent unemployment insurance. The first is that there is a greater need for insurance in economic downturns than in economic upturns because it takes more time to find a job in downturns. The second argument is that the negative effects of generous unemployment insurance on the unemployed's search intensity play a smaller role in a downturn, when there are few jobs, than in an upturn.

A new tax reform is needed

In 1990 and 1991 there was an extensive tax reform aimed at achieving a more just and socially more efficient tax system. By broadening the tax bases and reducing marginal taxes, the tax system became simpler and more uniform. Since this reform, there have been a number of changes made to the cohesive tax system it created. In recent years, these have included the earned income tax credit, the tax credit for household services and the Repair, Maintenance and Improvement (RMI) tax credit, lower social contributions for certain groups, a lower real estate tax, and abolition of the wealth tax.

Taxes have negative effects on household and business behaviour by driving a wedge between social and private returns. When they differ, businesses and households will not behave in a way that will maximise social efficiency. The tax structure should be designed so

that the social efficiency losses are as small as possible, and redistribution requirements are satisfied.

The Ministry of Finance should do more analysis of the effects of different tax changes on social efficiency. Today their analyses focus primarily on the employment effects and the impact on public finances.

Some tax changes since the 1990-1991 tax reform have made the tax system more socially efficient. This is particularly true of the earned income tax credit, which reduces the wedge between the social and the private return to working. Abolishing the wealth tax has also presumably been socially efficient. This tax reduced savings, led to an inefficient distribution of savings between different assets and induced a flight of capital and capital owners to other countries.

For practical reasons, only market activities can be taxed, unlike doing one's own household work and work in the unregistered sector. High taxes on services that can easily be performed by households themselves or in the unregistered sector therefore result in greater distortions than taxes on other services and goods. This is a strong argument for the tax credit for household services, which provides tax relief for the purchase of household-related services. The argument for tax relief for RMI work is weaker as it requires more professional skills. Nor are the social efficiency arguments for a lower VAT on restaurants and catering services particularly strong.

We recommend a return to a single VAT rate. The lower tax rates on such items as food, books and some tourist-related activities distort consumption in favour of these goods and services at the cost of others. Appropriately differentiated VAT rates can theoretically contribute to greater social efficiency but the current differentiation does the opposite.

The Government has used employment arguments to justify a number of tax cuts. For example, a lower restaurant VAT is assumed to lead to lower structural unemployment. It is questionable whether differentiated consumption taxes are the right instrument for addressing this problem. Tax reductions directed at weak groups (such as new start jobs) and those that affect incentives to work (such as the earned income tax credit) are more effective. Lowering social contributions for large groups such as young people is an ineffective method of increasing total employment. Young people risk displacing

other (considerably weaker) groups and the tax reductions may generally be assumed to lead to higher wages.

We are critical of the reduction made in the real estate tax on housing. It favours investment in housing and consumption of housing services at the cost of investments in other sectors, for example, the corporate sector, and other consumption.

The Government has announced in the 2011 Spring Fiscal Policy Bill an increase in the income threshold for the state tax and another step in the earned income tax credit. Even though these tax cuts increase the incentives to work, an abolition of the tax surcharge on high incomes is the income tax change most likely to provide the greatest social efficiency gains. Its abolition would lead to more hours worked and strengthen the incentives to get an education.

The tax system has become increasingly complex. In several areas, the tax changes have deviated from the fundamental principles of uniformity and neutrality on which the 1990/91 tax reform was based. Too much differentiation in the tax rates is ineffective and introduces arbitrariness. We therefore propose a cross-party inquiry to conduct a new complete overhaul of the tax system.

Education reforms need to be better targeted

The Government has announced and implemented a number of reforms in education policy. Part of the Fiscal Policy Council's remit is to assess whether developments are in line with long-term sustainable growth and employment. The education system is clearly connected to both growth and employment. This link justifies a review of this area.

The Swedish school has major problems that should be taken care of. According to international surveys, Swedish students' performance has worsened significantly since the 1990s. The education reforms' main principles are generally in line with the research. But we are not sure that the individual measures will suffice. The Government has great faith in norm-building signals. How the new regulations are in practice designed will be important for the results. Furthermore, the Government in our opinion has hardly done enough (if anything) to counter the increased segregation.

Several factors complicate the reforms. Local self-government makes it difficult for the Government to steer the school system.

Many inappropriate reforms were made in the 1990s. Teachers need time to adapt to new ways of working. It is not good to change the rules frequently. Furthermore, there is limited knowledge of what caused the results to deteriorate and of what will work.

Our conclusions about the policy pursued thus far are as follows.

- It is essential to continue to improve the possibilities for follow-up and evaluation. Some improvement has already taken place with the national tests now introduced in years 3, 6 and 9. The collection of test results has also improved. We take a positive view of the establishment of the Swedish Schools Inspectorate in 2007 and the announced evaluation unit. But there is room for improvement. In particular, the collection of statistics should be better.
- Grades should better reflect students' level of knowledge to overcome grade inflation. We see no other alternative than to introduce more national tests and make arrangements for marking them externally.
- The upper secondary school reform focuses more clearly on job skills in the vocational programmes. This is potentially a change for the better.
- We welcome the changes in the new Education Act that put independent and municipal schools on an equal footing. But the Government should consider rescinding the right of independent schools to use queue length as a selection criterion, as it probably increases social segregation. Supervision of existing independent schools, like those that wish to enter the market, should be further strengthened.
- From July 2011, the change in the Education Act providing that students should have continuous and active teacher support with structured instruction is a step in the right direction. Research indicates that more individualised instruction has contributed to the poorer results. But we doubt how effective the Government's changes will be in practice. We would like to see systematic studies of how different forms of instruction affect students' results.
- In our opinion, initiatives for teachers are insufficient to make a significant difference. There are good arguments for reconsidering the teacher certification system. We have more faith in a solution

in which skilled experienced teachers act as mentors to other, less experienced teachers or in some other manner helps schools with poor results.

- Course grades combined with goal-related grades at the upper secondary level have an element of stigmatisation. According to the research, they have resulted in more dropouts, particularly by students who are weak in general theoretical subjects. Therefore a return to subject grades should be considered.

The Government has good intentions in the education area, but concrete measures are not well targeted. We are convinced that more can and should be done. The increased funding allocated to schools is only a fraction of the amount allocated for labour market initiatives, for example: SEK 7-8 billion over a four-year period compared with SEK 70 billion a year on the earned income tax credit. Currently, there is less knowledge about what works than about what does not work. Therefore it is important already when introducing new work methods or regulations to see that they are introduced in a way that can be evaluated.