Stabilisation policy in the monetary union - a summary of the Swedish Government Official Report 2002:16

Membership in the monetary union will mean a change in the stabilisation policy regime because domestic monetary policy will disappear as an instrument to stabilise the economy. Instead, Sweden will participate in a common European monetary and exchange rate policy. The opportunity to use interest rate changes to counteract macroeconomic shocks that specifically affect the Swedish economy will then be lost. Nor can exchange rate adjustments vis-à-vis euro countries take place in response to such country-specific shocks.

The primary purpose of this report is to analyse the problems which may arise in this new stabilisation policy regime and to propose how best to pursue fiscal policy under these new conditions.

The report focuses on two basic issues. The first issue is whether the need for stabilisation policy may ultimately change as a result of EMU membership.[1] This in turn depends on the extent to which macroeconomic shocks that affect the Swedish economy will be different in the monetary union and on the extent of changes in the economy's ability to adapt to these shocks. The labour market plays a central role, particularly in the latter aspect.

The second issue is what can be done to make the stabilisation policy instrument that remains available to the government in the event of country-specific shocks – fiscal policy – as effective as possible.

This summary discusses the above issues. First, it examines the spontaneous adjustments in the economy that may take place if Sweden joins the EMU. This is followed by a discussion of how domestic fiscal policy should be pursued so as to contribute in the best possible way to stable macroeconomic developments.

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[1] Throughout this report, the concept 'EMU membership' is used as a synonym for participation in the monetary union. Even if this usage is formally improper, it is practical and is generally accepted.

Macroeconomic stability

Macroeconomic shocks

It is difficult to know in advance whether macroeconomic shocks will be larger or smaller in the monetary union than they would have been outside it. As a member of the monetary union, Sweden will be affected by new types of shocks, but will also avoid other types. Empirical studies do not provide a clear picture. Furthermore, since these studies are inherently based on historical data – while participation in the monetary union constitutes a radical structural change – their results do not necessarily provide an accurate guideline to future developments.

Continued integration and increased trade with euro countries will increase the Swedish economy's dependence on, and probably also covariance with, European economic developments. Cyclical fluctuations in Sweden will probably largely follow those of the euro area. The monetary policy of the European Central Bank will in that case help to stabilise the business cycle in Sweden as well. Increased specialisation of production among euro countries may, however, entail a greater risk of shocks that affect individual economies only. In addition, macroeconomic shocks in other parts of the monetary union may bring about changes in the interest rate and the euro rate, which may destabilise the Swedish economy. All in all, a monetary policy formulated for a group of countries will inevitably be a less sharp policy instrument than a monetary policy formulated specially for one particular country.

Consequently, it is difficult to draw safe conclusions about how the pattern of macroeconomic shocks will change in the event of participation in the monetary union, both compared with the present regime with a floating exchange rate and compared with the previous regime with a fixed but adjustable exchange rate. In the opinion of the Government Commission, there should be a readiness for shocks that in the absence of a national monetary policy would entail a greater risk of increased macroeconomic instability. This increases the demands on labour market adjustment and on fiscal policy.

The labour market's ability to adjust

The absence of a national monetary policy can lead to problems in the event of major fluctuations in the demand for products and services that do not affect other euro countries in the same way and therefore do not result in an appropriate monetary policy for Sweden. In such a situation, an adjustment of wage costs in relation to other countries may be necessary to keep employment stable. In the monetary union, this kind of adjustment must take the form of changed nominal wage costs.

EMU membership may increase the incentives for the labour market parties to achieve higher nominal wage flexibility, for example through shorter contract periods, clauses that tie wage growth to macroeconomic developments, more frequent renegotiations of existing agreements, and less resistance to low nominal wage increases. However, there is reason to believe that changes in nominal wage flexibility will be rather limited. This is related, not least, to difficulties in lowering the nominal wage level. At low rates of inflation there is limited scope for adjusting the wage level relative to other countries by lowering the rate of nominal wage increases.

It is possible that EMU membership will enhance the incentives for the labour market parties to co-ordinate their wage negotiations, since this is likely to increase nominal wage flexibility. This kind of development seems to have taken place in many EMU countries, for example through social pacts between labour market parties, in some cases with the government as a third party. However, it is doubtful whether this kind of co-ordination can work in the long run, since in a longer perspective strong forces seem to be working in the direction of more decentralised wage formation.

Our view is that changes in the degree of nominal wage flexibility are likely to compensate only to a minor extent for the loss of national monetary policy as an instrument of stabilisation policy.

Wage formation can also in itself constitute a source of shocks that could become more difficult to manage in a monetary union. There will no longer be any possibility of counteracting excessive Swedish wage cost increases by a tighter national monetary policy. As a result, the risk of wage cost shocks may increase. If wage formation is not functioning well, there is a risk of imbalances that can result in drawn-out adjustment processes with high unemployment. Parallels can be drawn to the effects that would have arisen if a depreciation of the krona had not taken place in connection with the transition to a floating exchange rate in 1992. In the absence of exchange rate adjustment, the adjustment of wage costs relative to other countries would instead have had to take place through a long period of smaller nominal wage increases than in other countries. Unemployment in the 1990s would then have been even higher than was now the case.

Buffer funds and other institutional changes

The Government Commission has had the task of analysing various instruments that can contribute to increased flexibility in wage costs. In the debate, special interest has been attached to so-called *buffer funds*. The idea is to build up funds that, in the event of a negative macroeconomic shock, could provide financial scope for lowering wage costs by reducing negotiated employer contributions to various insurance systems. In this way, wage costs can be redistributed over time.

In Finland, buffer funds have been set up primarily to prevent contributions to unemployment insurance and pension schemes being raised in recessions. This problem is not relevant in Sweden. The Swedish central government's budget acts, to a much greater extent than in Finland, as a stabilising buffer. However, the option of lowering negotiated employer contributions in a recession is of interest.

Our opinion is that under the auspices of the labour market parties and if constructed properly, a system of buffer funds could increase the economy's ability to adjust, thereby helping to moderate cyclical fluctuations. If such funds are set up, they should be administered by the labour market parties themselves without any government involvement, so as to make the division of responsibilities between the government and the parties with respect to wage formation as clear as possible. Any such funds should be reserved for strong, negative shocks and should not be used routinely as a stabilising instrument. Furthermore, the funds should only be used for general reductions in contributions, so that they do not constitute support to particular sectors or regions, and thereby risk slowing down a necessary structural change. If the labour market parties agree upon such a system, it should be welcomed, but the advantages are not so great as to justify government subsidies.

Continued economic integration with other countries entails increased competition for Swedish companies, which in turn increases the demand for skills development and mobility between jobs. Mobility can be encouraged by existing instruments within education and labour market policy and by new instruments such as career change insurance (*omställningsförsäkring*) and learning accounts (*kompetenskonton*). Tax policy and the design of unemployment insurance are also of great importance in this regard. Increased mobility and improved opportunities for skills development can contribute to stabilising employment in the case of shocks that cause shifts in employment between sectors. EMU membership may speed up the integration process to a certain extent, but the Government Commission's opinion is that requirements for skills development and mobility will be similar regardless of whether Sweden joins the EMU or not.

According to its terms of reference, the Government Commission is to analyse whether instruments taking the form of performance-based wages, flexible working hours or learning accounts can enhance the economy's ability to absorb economic shocks. Based on the above opinion that requirements for skills development and mobility will be similar regardless of whether Sweden joins the EMU or not, our conclusion is that such instruments should be assessed on their own merits and cannot be viewed as special requirements raised by EMU membership.

However, if a system of individual learning accounts were to be introduced to structurally promote skills development and mobility, there are reasons for designing it to allow stabilisation policy aspects to be taken into account when it comes to the timing of recurrent education. Our opinion is, however, that this instrument can only contribute marginally to stabilising employment. Adjustments to the business cycle can also take place within the framework of existing education systems.

Working hours are and should remain an issue for the labour market parties, besides the legislation that is warranted for working environment or safety reasons. Variations in working hours cannot serve as a general stabilisation instrument, since in a recession, for example, reducing working hours in sectors or personnel categories not subject to decreasing demand would be associated with considerable social costs. In our opinion, there is no justification for the government to undertake measures for stabilisation reasons aimed at increasing the variation in working hours over the business cycle.

There are several arguments supporting performance-based pay schemes. It is likely that such schemes are capable of leading to higher output and higher employment on average over the business cycle. However, it is less clear whether such schemes contribute to moderating fluctuations in output and employment.

Fiscal policy

The Government Commission's conclusion is that the changes that can be predicted in the pattern of macroeconomic shocks and the economy's ability to adjust will not be able to compensate for the loss of national monetary policy. In the future too, there will continue to be a need for national stabilisation policy, which in the event of EMU membership must be pursued through fiscal policy only.

The role of stabilisation policy

The Government Commission's view of the role of fiscal policy in stabilising the business cycle is to a great extent based on what currently appears to be the general perception of stabilisation policy. This can be summarised as follows. The experience of many countries has shown that a lack of a long-term perspective has tended to make stabilisation policy systematically too expansionary. Examples include the developments in Sweden in the 1970s and 1980s, and Germany's situation in the 1990s. Stabilisation policy has often not been tightened sufficiently in times of booms, which has consequently limited the room for manoeuvre during recessions. Also, fiscal policy changes have often been carried out at times that were inappropriate from a stabilisation policy point of view.

A tangible result of previous stabilisation policy experiences in most OECD countries is that the main responsibility for stabilisation of the economy has been transferred from fiscal to monetary policy, and that monetary policy has been delegated to independent central banks. The purpose of such delegation to a central bank, which operates 'at arm's length' from current politics, is to increase the credibility of a low-inflation policy and to decrease the risk of measures being undertaken at points in time that are inappropriate from a stabilisation policy standpoint. Greater credibility in turn creates more scope for measures to stabilise the economy.

In conjunction with this development, the long-term perspective of fiscal policy has also received more emphasis through commitments at both EU and national level. One example of this is the fiscal policy rule at the EU level that a deficit in public sector net lending may only in exceptional cases and temporarily exceed three per cent of GDP. Other examples are the target for general government net lending and the expenditure ceiling in Sweden. Consolidation of the formerly very strained public finances in many countries has also contributed to giving monetary policy the required scope for action.

These new institutional frameworks for stabilisation policy appear to have mitigated the problems that were previously associated with active economic stabilisation.

The changed role of fiscal policy in the monetary union

Participation in the monetary union means that Sweden leaves a situation where stabilisation of the domestic economy is primarily effected by an independent authority, that is, the Riksbank, which has this task as its main objective. Domestic stabilisation has instead to be managed through fiscal policy, which also has many objectives other than to stabilise economic activity. This entails a risk that the long-term perspectives of stabilisation policy may be set aside for more short-term considerations.

The various types of fiscal policy rules that have been introduced in recent years have reduced the risk of failures in stabilisation policy, but there is nevertheless a risk that fiscal policy discipline will gradually grow lax as the memory of previous deficit problems fades away. The current international debate on loosening the restrictions imposed by the Stability and Growth Pact, and the fact that several euro countries are having difficulty pursuing a sufficiently tight fiscal policy in times of prosperity, illustrate the point that many countries are under considerable pressure to pursue an excessively lax fiscal policy. In Sweden, the so-called budget margin – the difference between the government expenditure ceiling and estimated expenditure – has come to be viewed more as ‘room for new expenditure increases’ than as a safety margin for dealing with uncertainty in expenditure forecasts. In addition, certain ‘reforms’ in recent years have taken the form of tax cuts (‘tax expenditures’) rather than spending increases so as to avoid the limitations that the expenditure ceiling is meant to impose. These tendencies give cause for concern since strong public finances, which provide scope for using fiscal policy during macroeconomic shocks, are of greater importance in the event of membership in the monetary union than now.

The formulation of a stabilisation policy target for fiscal policy

EMU membership should mean a change in the target for domestic stabilisation policy. In the case of participation in the monetary union, the need for a domestic anchor for the long-term rate of inflation disappears. The nominal anchor instead consists of the ECB price stability target. EMU membership can thereby partly be seen as a return to the stabilisation policy regime that Sweden attempted, but failed to maintain, through a fixed exchange rate in the 1970s and 1980s. The difference is that EMU membership would create a situation that would be basically the same as if Sweden had a completely credible exchange rate vis-à-vis other euro countries.

Since national stabilisation policy will no longer need to provide a nominal anchor in the event of EMU membership, the natural conclusion in our opinion is that fiscal policy, given a specified long-term target of general government net lending over the business cycle, should have as its primary stabilisation policy target to *counteract major fluctuations in the level of activity* both in the short and medium term. Expressed in more technical terms, the output gap (the difference between actual and potential GDP) must not grow too large. This target may also be interpreted as implying that policy is to counteract major fluctuations in employment and unemployment from their equilibrium levels. The target of stabilisation policy should be forward-looking, since it is difficult to influence the level of activity in the short term without great variations in taxes and government expenditure.

The target of domestic stabilisation policy in the case of EMU membership is of necessity more ambiguous than in the current monetary policy regime with an inflation target, since the assessment of the size of the output gap is relatively uncertain. However, if the aim of stabilisation policy is to stabilise the level of activity, this constitutes an unavoidable problem. In principle, similar difficulties also exist in the current monetary policy regime, since inflation forecasts are based on, among other things, estimates of the output gap. In practice, therefore, such estimates are also crucial for monetary policy decisions. However, the difficulties in estimating the output gap provide a strong motive for undertaking fiscal policy measures to stabilise the economy only in the event of major shocks.

Even if the objective of stabilising the output gap can be construed as an objective to stabilise employment and unemployment, there are several reasons for formulating the target in terms of the output gap. One reason is that the output gap is a wider concept that reflects the level of activity in the economy as a whole and not only the situation in the labour market. A focus on stabilising the output gap therefore takes more stabilisation policy aspects into consideration than a target that only focuses on the labour market situation, particularly the stabilisation of the income level in the economy.

The main reason for our recommendation to focus on the output gap instead of on the labour market situation per se as a target for fiscal policy is the ambiguity of macroeconomic objectives which could otherwise arise. This point is related to the fact that Swedish macroeconomic policy already works with targets for employment (80 per cent of the working-age population) and unemployment (4 per cent of the labour force). These targets must be viewed as targets for equilibrium levels (average long-run sustainable levels), which are to be achieved through a *structural* employment policy that leads to a well-functioning labour market. It might be problematic to simultaneously formulate a different short-term employment target for fiscal policy, that is, to stabilise employment at the currently prevailing equilibrium level, which may deviate from the long-term target.

An assessment of the output gap must be based on the careful appraisal of a number of indicators, such as the development of prices and wages, estimates of the long-term trend in GDP using statistical methods, and various measures of 'shortages' in the product and labour markets.

Price and wage cost developments relative to other countries are particularly relevant indicators of the possibilities of stabilising the level of activity. If price and wage cost increases are higher in

Sweden than in other euro countries – and this is not balanced by long-term shifts in demand toward Swedish products or higher productivity growth – competitiveness will gradually be weakened. This will make it more difficult to achieve the target of stabilisation policy in the medium term. The reason for this is that the difficulty of adjusting wage cost increases downward means that drawn-out adjustment processes will be needed to correct for a cost level that has become too high. Accumulated cost problems due to faster cost increases than in other countries can therefore result in fiscal policy being unable to counteract major declines in output and employment in the medium term. Therefore, when formulating fiscal policy, great importance should be attached to price and wage cost developments in relation to other euro countries.

Faster price and wage cost increases in Sweden than in other countries may often be due to an increase in demand that has caused actual GDP to exceed the potential (sustainable) level. A policy that dampens the economy relatively quickly will then improve the conditions for macroeconomic balance in the short as well as the medium term.

Another possibility is that a wage cost shock – an ‘asymmetric supply shock’ – will arise in the Swedish economy. For example, this may occur if wage negotiations in a situation not characterised by particularly high demand result in multi-year agreements with higher wage increases than in other euro countries. Since higher wage cost increases in a given economic situation can be interpreted as a decrease in sustainable employment and output levels, this could be interpreted as reflecting the existence of a positive output gap. Therefore, no conflict arises between stabilisation in the short and medium term. A tighter fiscal policy is justified by both the positive output gap and the higher wage cost increases relative to other euro countries.

A fiscal policy that reacts in this way to higher wage increases than in other euro countries should boost incentives for wage restraint, thereby exercising a positive influence on the long-run sustainable levels of output and employment. If fiscal policy is formulated in this way, it can, at least to some extent, take over the restraining effect that national monetary policy at present exerts on wage formation.

Discretionary fiscal policy and automatic stabilisers

As discussed above, there has earlier been a tendency to pursue an excessively expansionary fiscal policy in Sweden. With membership in the monetary union, such a tendency would primarily manifest itself in the form of large budget deficits and growing government debt, but also in a rise in the domestic price level relative to other countries. These risks explain why a discretionary fiscal policy – that is, a policy of active decisions to change tax rates and government expenditures with the aim of stabilising the economy – should be used with caution in the event of participation in the monetary union. In the EMU, fiscal policy should not be used as actively as national monetary policy in a regime with a floating exchange rate.

In the case of ‘normal’ shocks, stabilisation besides that which occurs through the monetary policy of the ECB, should primarily take place by means of the automatic stabilisers, that is, the changes in tax payments and government expenditures that are automatically induced by variations in the level of activity. Discretionary fiscal policy should only be used for stabilisation purposes in the event of major macroeconomic imbalances. In the absence of major shocks, discretionary fiscal policy should focus on attaining the target for general government net lending over the business cycle, as laid down by the Riksdag (the Swedish parliament).

It is difficult to define when a shock is sufficiently large to justify discretionary fiscal policy measures. One reasonable way of characterising a ‘major’ shock would be as an output gap of at least plus or minus two per cent of potential output. On the basis of the limited evidence available on the link between the output gap and unemployment in Sweden, the Government Commission judges that a change in the output gap of two percentage points corresponds to a change in open unemployment of approximately one per cent.

At the same time, it is uncertain how the relation between fluctuations in output and fluctuations in (un)employment has been affected by the considerable structural changes in the Swedish economy in the past decade, and what effects will arise if Sweden joins the EMU. The definition of what can be considered a major shock may therefore need to be reviewed in the future. In addition, there may be reason to further study the issue of whether discretionary fiscal policy should be asymmetric, in the sense that measures should be triggered by smaller output gaps in booms (when they are positive) than in recessions (when they are negative). The reason for considering such asymmetry is that price and wage increases tend to accelerate relatively quickly in booms, but are more sluggish downwards in slumps.

Active labour market programmes, which can be seen as a form of 'semiautomatic' stabilisers, should continue to be used as an active stabilising instrument also during minor shocks. These measures seem on the whole to have been well timed, although the volume of measures during the crisis in the early 1990s was excessive. It is important that labour market programmes are not used to such an extent that they become ineffective and that they do not become permanent, but are phased out quickly in an economic upswing. Nor should labour market policy measures be used so as to keep open unemployment down at the expense of major negative effects on regular employment.

The target for government net lending

To create scope for automatic stabilisers as well as discretionary fiscal policy, public finances should show a surplus over the business cycle. The size of this surplus should depend to a great extent on the room required for fiscal policy to provide stimulus during major negative shocks. The EU fiscal policy rule that a deficit in public finances may only in exceptional cases and temporarily exceed three per cent of GDP is an important restriction that must be taken into account. From a more general point of view, it is important that there is sufficient room for manoeuvre so that discretionary measures can be undertaken in slumps without risking developments in government finances that are seen as untenable, which would limit the effect of the stimulus.

Empirical estimates do not give a clear picture of the margins needed to provide room for automatic and 'semiautomatic' stabilisers without coming into conflict with the Stability and Growth Pact's deficit rule. A reasonable overall judgement is that a surplus of at least one per cent of GDP is required on average over the business cycle to provide room for the automatic and semiautomatic stabilisers to work.

To achieve the objective of maintaining output and employment near their potential levels, there should also be considerable room for discretionary expansionary fiscal policy in the event of major negative shocks. It is difficult to calculate exactly how much additional room may be required, since such discretionary stimulus measures lead to higher GDP and thereby higher tax receipts and lower expenditure on unemployment compensation, etc., than would otherwise have been the case.

In our opinion, there may be justification for increasing the target for government net lending over the business cycle from the current level of 2 to 2.5 or, alternatively, 3 per cent of GDP, so as to provide a satisfactory safety margin for discretionary fiscal policy stimuli in recessions. Maintaining the present target entails a greater risk to stabilisation policy.

A target for net lending of the size proposed should apply in the first place for the next ten-year period. A review should thereafter be conducted in light of demographic developments and changes in the state of public wealth. Furthermore, it is possible that the EU’s fiscal policy rules will eventually change, which would then call for a revision of the Swedish target for net lending.

The expenditure ceiling

The central government expenditure ceiling plays an important part in securing the strong public finances required to make fiscal policy an effective stabilisation instrument. At the same time, the expenditure ceiling should not unduly constrain fiscal policy as a stabilisation policy tool. In order for the automatic stabilisers to achieve full effect in a recession, there must be enough room on the expenditure side of the central government budget. Appropriate fiscal policy measures to stabilise the economy during major negative shocks may also include increased central government expenditure. There must be room for such expenditure increases too under the expenditure ceiling. The expenditure ceiling should therefore be constructed in such a way that there is always a margin for stabilising the economy through increases in expenditure should a major shock arise. This should be accomplished by creating a special *margin for cyclical expenditure*. This margin is not to be utilised for any purpose other than expenditure increases that derive automatically from cyclical developments, including labour market policy measures, or for discretionary fiscal policy decisions aimed at stabilising the economy during major shocks. Expenditure increases for other reasons ('reforms') should not be allowed to reduce the margin for cyclical expenditure.

In our opinion, the margin for cyclical expenditure should amount to approximately three per cent of the expenditures restricted by the ceiling. This would provide sufficient budget room for managing even a protracted recession.

Beside the margin for cyclical expenditure, there should be a *planning margin* to provide room for additional 'reforms' that will increase expenditure. The planning margin may also be negative, in which case it requires expenditure cuts. Expenditure deviations resulting from factors other than cyclical reasons, for example a change in the pattern of sick leave, should be included in the planning margin. The planning margin should therefore be determined so that it covers uncertainty in forecasts arising from factors other than the business cycle, to the extent that the government does not wish to balance increases in such expenditures by decreases in other expenditures.

Local governments and stabilisation policy

During an economic slowdown, the balanced budget requirement that has applied to municipalities and county councils since 2000 can result in a decrease in the level of activity and employment, thereby compounding the slowdown. This is not an argument for a revision of the balanced budget requirement. However, there are reasons for considering a system whereby municipalities' and county councils' incomes will be stabilised over the course of a business cycle. This would also be a way to strengthen the automatic stabilisers without any negative consequences for economic efficiency in the form of larger tax wedges. The model that should be primarily considered is to base the local government tax base on an average of taxable income over several years. Alternatively, the rules for central government grants can be formulated so that they compensate completely or partially for the effects of the business cycle on the local government tax base. These alternatives should be investigated further.

Discretionary fiscal policy measures

A key issue is which stabilisation policy measures, that is, specific taxes and expenditures, the government should primarily utilise. One criterion should be that fiscal policy measures to stabilise the economy should have as *general* demand effects as possible, but at the same time as small effects on income distribution and resource allocation as possible. In addition, fiscal policy measures should be used only *temporarily*, that is, only for relatively limited periods, and *symmetrically*, so that tax cuts in recessions are compensated by equivalent increases during periods of high economic activity, etc. The aim is to ensure that the measures undertaken do not give rise to a systematic weakening of public finances or undesirable structural changes in the tax and expenditure systems.

To speed up decisions on discretionary fiscal policy measures and increase the chances that policies are indeed used countercyclically, it would be appropriate for the Riksdag to decide on a few appropriate fiscal policy measures in advance, which should be used to stabilise the economy in the event of macroeconomic imbalances.

In our view, the primary measures that should be considered for stabilisation policy purposes are variations in value-added tax, personal income tax, payroll taxes, government consumption, and government investment. In the case of a major fall in output and weak public finances, an *internal devaluation*, that is, a lowering of payroll taxes financed by rises in other taxes or charges could be considered.

The institutional framework of fiscal policy

As stated above, the institutional framework of fiscal policy in recent years has been reformed in a way that decreases the risk of stabilisation policy failures. However, as we have argued, EMU membership will make fiscal policy increasingly important as a stabilisation policy tool. This justifies further steps to ensure that fiscal policy is pursued in a way that is desirable from the perspective of stabilisation policy.

Therefore, in the opinion of the Government Commission, an independent advisory body, a *fiscal policy council*, should be set up. The role of this council would be to monitor cyclical developments and give recommendations on the stance of fiscal policy on the basis of guidelines laid down by the Riksdag and the government. The establishment of a fiscal policy council of this kind could be seen as a complement to the fiscal policy rules that were gradually introduced in the 1990s, particularly the target for net lending and the reformed budget process incorporating an expenditure ceiling. Similar advisory bodies already exist in several countries, for example Denmark and Germany.

A fiscal policy council could help to stimulate and give a better basis for the public debate on stabilisation policy, as has happened in the field of monetary policy.

Two conditions, above all, would probably need to be fulfilled for this type of advisory body to function satisfactorily. First of all, the council should be guaranteed a sufficient degree of independence. Secondly, it is essential that the government takes a public stand and comments on the recommendations that are given. One method of ensuring this is that the council's analyses and recommendations are published in public reports to which the government is obliged to react.

In our opinion, the fiscal policy council should be an authority under the government. Appointments to the council should be made according to a rolling schedule with overlapping mandate periods, as is the case with the Riksbank's Executive Board. A mandate period of three to five years seems appropriate. The fiscal policy council should consist of academic economists and experts with previous experience from bodies such as the Ministry of Finance, the Riksbank or international organisations that work with macroeconomic issues. The members must not have other assignments that could call the independence of the council into question. The members should have good insight into public finances and expertise in the fields of macroeconomics and stabilisation policy.

The analyses and recommendations of the fiscal policy council should be presented in the form of reports twice a year, once at the beginning of March to form the basis of government and Riksdag work on the Spring Budget Bill, and then in early August for the Budget Bill. The intention is that the recommendations of the fiscal policy council should serve as a basis for the government's budget negotiations in the spring and autumn.

Fiscal policy co-ordination within the EU

The current attempts at co-ordination of fiscal policies as a stabilisation policy tool in the EU are mainly of a supervisory and informal nature. They entail no binding regulations directing individual countries beyond the norms for budget discipline; instead, they manifest themselves in the form of recommendations, good examples, peer pressure, etc. From a theoretical point of view, it is unclear what effects co-ordination of fiscal policy stabilisation efforts would have on the countries in the euro area. The few empirical studies that have been made lend scant support to the idea that there are significant potential gains to such fiscal policy co-ordination. Moreover, there is reason to believe that considerable co-ordination costs and practical problems may be associated with further fiscal policy co-ordination in the monetary union, while the difficulties in making well-balanced stabilisation policy decisions are probably even greater at the EU level than at the national level.

More extensive and formalised fiscal policy co-ordination at the EU level also risks limiting the scope for national action as regards undertaking measures quickly during serious macroeconomic shocks. We believe that it is of great importance to maintain national scope for fiscal policy action when participating in the monetary union, since fiscal policy will then be the only available instrument of stabilisation policy at a national level. Therefore, in our opinion, there is no reason to support any proposals for more formalised and more extensive co-ordination of discretionary fiscal policy within the EU. However, from a credibility standpoint, it is important to strictly follow the EU rules for fiscal policy that apply at any given time and not adjust them to each circumstance.

The Government Commission’s proposals:

- The Riksdag (the Swedish parliament) should set a *basic framework* for pursuing fiscal policy in the event of Sweden’s participation in the monetary union, with the following guidelines:
  - The stabilisation objective of fiscal policy shall be to counteract major deviations from the sustainable level of output (potential output) in the short and medium term. This is equivalent to stabilising employment and unemployment near their equilib-

rium levels. Assessments regarding the existence of an output gap, that is, a deviation of output from the sustainable level, are to be based on a number of indicators. Particular importance should be attached to price and wage cost developments in relation to other euro countries. Price and wage cost developments on a par with the developments in other euro countries are crucial to the chances of achieving macroeconomic stability in the medium term.

- Discretionary fiscal policy shall only be used for stabilisation purposes during major shocks, roughly equivalent to an output gap of at least plus or minus two per cent. During minor shocks, stabilisation should take place through the automatic stabilisers. It should also be possible to vary the extent of labour market programmes in response to minor economic shocks.
- To create room for automatic stabilisers and discretionary fiscal policy during major shocks, general government net lending should amount to 2.5, or, alternatively, 3 per cent of GDP on average over the business cycle. This should create a satisfactory safety margin even during relatively protracted recessions.
- To ensure sufficient room for stabilisation policy, the budget margin below the expenditure ceiling should be divided into a margin for cyclical expenditure and a planning margin. The margin for cyclical expenditure must not be utilised for any purpose other than increases in expenditures deriving automatically from cyclical developments, including labour market policy measures, or for discretionary fiscal policy decisions to stabilise the economy in the event of major shocks. The margin for cyclical expenditure should amount to approximately three per cent of the expenditures restricted by the ceiling. The planning margin is to cover uncertainty in forecasts arising from factors other than the business cycle to the extent that the government wishes to avoid balancing increases in expenditure of this type by other changes that decrease expenditures. The planning margin should also include a specified room for increases or decreases in central government commitments, which means that it can be positive or negative.

- An advisory body, a *fiscal policy council*, should be set up with the task of analysing macroeconomic developments and making fiscal-policy recommendations based on guidelines determined by the

Riksdag. The design of the council and its activities should be regulated by specific legislation.

- The fiscal policy council should be an authority under the government, but independent. Its members must therefore not be closely associated with the political system or interest groups. Nor should the members have other assignments that could call the independence of the council into question.
- The council should consist of a balance of academic and practising economists with good insight into public finances and expertise in the fields of macroeconomics and stabilisation policy.
- The council's analyses and recommendations should be presented twice a year, once at the beginning of March to serve as a basis of government and Riksdag work on the Spring Budget Bill, and then in early August to serve as a basis for the work on the Budget Bill. The council should also be empowered to propose stabilisation policy measures in between the half-yearly reports on its own initiative, if this is deemed necessary, for example in the event of a major macroeconomic shock.
- The recommendations of the council should focus strictly on stabilisation policy. They should primarily refer to amounts for unfinanced tax and expenditure changes, but could also cover other stabilisation aspects of fiscal policy, including changes in specific taxes and expenditures.
- The government should take a stand on the recommendations of the council and justify deviations from them. It should be natural for the Riksdag to consult the council in connection with readings of the budget bill.

- The government should select a small number of appropriate fiscal policy measures in advance for use as policy tools during major macroeconomic shocks. These instruments should, as far as possible, be general and have as small effects as possible on income distribution and resource allocation. The aim is to shorten decision lags for discretionary fiscal policy measures by more clearly defining appropriate measures in advance that primarily give stabilisation policy effects and are thus politically uncontroversial in the sense that they do not have a major impact on income distribution or social efficiency. In the event of EMU membership, the choice of measures of this nature can be justified by the need to find a substitute for national monetary policy, which in itself is a general stabilisation policy tool. The measures that are undertaken are to be adapted to the type of shock that has arisen and should be used for a limited time period fixed in advance.

- To strengthen the automatic stabilisers, local government income should be stabilised over the business cycle. The primary model that should be considered is to calculate the local government tax base on the basis of an average of taxable income over several years. Alternatively, central government grants can be formulated so that they automatically compensate for the effects of the business cycle on the local government tax base. The exact model for such stabilisation of the incomes of local governments should be investigated further.