Swedish Fiscal Policy

Report of the Fiscal Policy Council 2010

Principal Conclusions and Summary

Principal Conclusions of the Report

- The global public finance problems pose major risks. The worries have thus far primarily concerned the euro area. There should be even more concern that the growing public debt in the United States, Great Britain and Japan will have adverse effects on the business cycle.
- Uncertainty about the long-term effects of the crisis makes it difficult to assess the room for costly reforms in Sweden. We would strongly advise against further promises of *permanent* reforms that are not financed by expenditure cuts or tax rises in the election campaign.
- But because of the strong public finances in Sweden, there is room for manoeuvre in stabilisation policy. There is a political choice of whether to use it for limited and *temporary* stimulus measures or for rapidly restoring the public finance buffers for the future.
- *If* fiscal policy is to be more expansive in 2011, an extension of the temporary grants to local governments is the most obvious option. But there is a risk that these grants may be regarded as permanent. The Government therefore needs to speed up the work on designing a *framework* for smoothing local government revenue over the cycle.
- We welcome the proposal to make it statutory for the Government to set a surplus target. But we are critical of the continued lack of clarity on how this target is to be interpreted. We recommend judging whether the target has been met with the help of only *two* indicators: a backward-looking indicator and a partially forward-looking one. In the event of deviations of a certain magnitude, the Government should, in a *special communication to the Riksdag* (the parliament), explain how it intends to act.
- High youth unemployment has been much debated. But youth employment relative to employment for the population as a whole has developed about the same as in previous recessions. Relative employment growth for people born outside Europe has now been better than in the 1990s crisis, but it has been worse for the low-skilled.

- The earned income tax credit can be expected to be effective in increasing employment in the long run. From the standpoint of employment, it is wise not to phase it out for higher incomes. But the Government should be criticised for its reluctance to explain how the credit works.
- It may be reasonable to tax earned income and pensions differently if raising employment is a priority. But the earned income tax credit also redistributes income between pensioners, who did not benefit from it when they were working, and younger workers. If this is to be avoided by means of tax reductions for older people, these cuts should be linked to *year of birth* and not given permanently to everyone over 65.
- The economic arguments are stronger for a permanent tax credit for household services than for a permanent Repair, Maintenance and Improvements (RMI) tax credit. The RMI tax credit should be reexamined when the economy picks up.
- Labour market policy has learned from the mistakes of the overexpansion during the 1990s crisis. But the pendulum has swung too far in the other direction. Job search activities and coaching have expanded too much in the economic downturn, while there has been far too little labour market training.
- The Government should be commended for tackling a difficult problem with its reforms to sickness insurance. But it must also be criticised for being overly hasty and remiss in its implementation of the reforms and its treatment of people on long-term sick leave.
- There is general agreement on the value of expanding regular education in an economic downturn. But there is little knowledge of how variations in regular education should be used as a counter-cyclical policy tool. There is a risk that regular education has overexpanded because it has been used as a means of support for the unemployed.
- In the debate on unemployment insurance, the Government has referred to the large volume of supplementary insurance schemes provided by unions or in collective agreements. The survey we conducted indicated a surprisingly low use of this insurance.

Summary

The ongoing crisis in the world economy is the worst since the 1930s. The crisis started as a financial crisis but then grew into a deep recession. An international recovery has now begun but uncertainty about its strength is unusually high. It is also very difficult to judge what long-term effects the crisis may have on employment and growth.

The large budget deficits in the world around us pose major risks

The economic crisis has led to a sharp deterioration in the public finances of almost all the most economically developed countries. The total budget deficit this year is expected to be about 8.5 per cent of GDP in the OECD area and about 7 per cent of GDP in the EU. The budget deficit in Greece, Ireland, Great Britain and the United States is around 10 per cent of GDP or even higher.

On account of the large budget deficits, the public debt is increasing very rapidly in many countries. According to the OECD, general government gross debt at the end of 2010 is expected to come to 197 per cent of GDP in Japan, 92 per cent in the United States and 83 per cent in Great Britain. For the EU as a whole, gross debt is expected to be 88 per cent of GDP.

The deficit has risen as a result of the crisis support for the financial markets, the working of automatic stabilisers (i.e., tax revenues have declined and various transfer expenditures have increased as production and employment have fallen) and the active fiscal stimulus measures aimed at counteracting the downturn. At the same time, many countries face severe long run *sustainability problems*. These problems are partly due to the fact that the deterioration in the public finances during the crisis followed from the weak starting position before the crisis. But even more important are the future demographic developments with a gradually ageing population. Most countries have not yet adapted their policies accordingly.

A rapidly growing public debt in a country may cause doubt among lenders about its ability to service the debt. These risks have been more than convincingly illustrated in the case of Greece. The public finances can get into an unsustainable situation in which *snowball effects* lead to an uncontrolled increase in debt that ultimately forces the country to default on its outstanding debt. Lenders command higher risk premiums on interest rates when the budget deficit rises. This in turn results in the deficit rising even more. The higher interest rates on government borrowing may spread to other interest rates and thus slow down growth. If so, the debt-to-GDP ratio increases even more rapidly and leads to escalating interest rates, resulting in a vicious circle.

The interest rate hikes just described seldom occur gradually. Instead they happen suddenly and rapidly once a *critical debt level* has been passed. This critical debt level may differ sharply between different countries and time periods.

Interest rate reactions in the financial markets have forced fiscal consolidations in Greece, Ireland, Portugal, and Spain. No such interest rate reactions have yet occurred in Japan, Great Britain or the United States. But the risks of such reactions suddenly appearing are very large. They may then have either direct negative effects on economic growth or indirect effects because they force large fiscal consolidations that may delay or, in the worst case, reverse the international economic upturn. The same thing may happen if major fiscal consolidations are implemented as a preventive measure. In both cases, there will be a strong impact on economic growth in the Swedish economy on account of its high export dependency. Consequently, there are substantial risks that the recovery may be considerably weaker than estimated in the main forecasts of both the Ministry of Finance and the National Institute of Economic Research.

Despite the support package for Greece from the euro countries and the IMF, there is still a considerable risk that the country at some stage will be forced to write down its outstanding government debt. If so, this will lead to credit losses for lenders. It is not clear that support measures from other EU countries and the IMF would suffice if Portugal and Spain were to face similar problems as Greece. The consequence could be acute new problems in the financial markets with strong negative effects on the international business cycle. Exchange rate developments are a particularly uncertain factor. If the krona were to strengthen substantially as a result of public finance problems in other countries, it could have large negative effects on Swedish exports.

Much better situation in Sweden but *room for reform* still uncertain

Swedish fiscal policy also faces a trade-off between long-term sustainability and short-term stabilisation. However, the situation in Sweden differs sharply from that in most other countries. According to current forecasts, Sweden will be one of only three EU countries this year that will have a deficit of less than three per cent of GDP, the threshold in the Stability Pact. Sweden is also one of the few EU countries that is not subject to an *excessive deficit procedure*.

There are two main reasons why public finances in Sweden are relatively good despite the economic crisis. The first is the strong public finances going into the crisis for which both previous governments and the current government should be commended. The second main reason is that the public sector did not need to intervene with crisis support to the financial sector in the same way that happened in many other countries. The sharp fall in the cost of sick leave has also been of importance.

Sweden has had substantial room for manoeuvre in using fiscal policy as a stabilisation policy instrument in the crisis. This has made it possible both to let the automatic stabilisers work and to take discretionary stimulus measures. According to our view, the stimulus measures were too small in 2009. The Government was then, in the opinion of the majority of Council members, overly cautious and underestimated the room for manoeuvre created by the fiscal framework that came into existence at the end of the 1990s. This assessment gets some support in the calculations we commissioned leading up to this year's report, which indicate that Sweden is far from the critical debt threshold where the interest on government debt is at risk of rising sharply. The fiscal policy stimuli in the current year are stronger than in 2009. In our opinion, they are of reasonable volume.

The Government expects public finances to return to surplus in 2012. This is expected to take place without any active decisions on consolidation measures. The forecast for the public finances in the National Institute of Economic Research's March report is even more optimistic. In the Spring Fiscal Policy Bill, when the expected public finance developments are compared with the target of a surplus of one per cent of GDP over a business cycle, the

Government's conclusion is that "taking into account the economic situation, there is limited room for additional unfinanced reforms in 2011." It is also stated that "there is some room for reform looking at the whole (the next, our comment) term of office", but there is so much uncertainty that "it should not be used up in advance".

We want – even more than the Government – to emphasise the great uncertainty. It is primarily due to the difficulty assessing what permanent effects the crisis may have on employment. Earlier sharp downturns in employment in many countries, including Sweden, have had very long-term effects.

The Spring Fiscal Policy Bill contains proposals for permanent reforms amounting to almost SEK 7 billion in 2011. The reforms are of limited size. Hence, despite the great uncertainty about future room for reform, it is difficult to maintain that they would jeopardise the long-term sustainability of fiscal policy. But we strongly advise against further promises of *permanent* reforms that are not financed by expenditure cuts or tax rises in the uncertain situation that now prevails. This uncertainty in all likelihood will not have cleared up by the time of the election in September. To put it plainly, it would be very risky if the Government and/or the opposition in the election campaign were to commit themselves to costly reforms without specifying the financing.

There is some room for manoeuvre in *stabilisation policy*

Sweden, unlike many other countries, does not have to undertake a rapid consolidation of the public finances. Instead the Government can choose the pace of consolidation. The fiscal policy announced will be slightly contractionary in 2011. It is not obvious, however, that fiscal policy should have this stance when resource utilisation is still low. The question is what trade-off to make between stabilising the economy and restoring the public finance buffers for the future.

We share the Government's opinion that it is essential to return to a surplus in the public finances within a reasonable time in order to maintain fiscal credibility. At the same time, our analysis shows that there is hardly any binding sustainability restriction on limited and *temporary* stabilisation policy measures.

If a more expansive fiscal policy is to be chosen in 2011, an extension of the extra grants to local governments for 2010 is the most obvious option. If so, the aim would be to try to achieve some increase in employment in the local government sector in 2011 (after it fell in 2009 and 2010) in a situation where there is still low resource utilisation.

But there is also an argument against extending the extra grants to local governments. One such argument is the risk that an extension of the temporary grants would result in their being perceived as permanent. That could make it difficult to stop paying them when the economic downturn is over. This risk is partly due to the fact that these grant increases are now discretionary decisions taken from year to year.

We have previously argued that a rules system should be introduced in which the grants to local governments routinely vary counter-cyclically. This would mean that grants increase more when the local government aggregate tax base in economic downturns grows more slowly than the long-term trend and increases less in economic upturns when this tax base grows more rapidly. With such a rules system in place, local governments would presumably be allocated extra resources in a year with low growth like 2011. It is important to get such a system in place as rapidly as possible. This issue will now be the subject of an inquiry. Given the importance of this issue, it is surprising that it has taken so long to get the review announced in the 2009 Spring Fiscal Policy Bill started.

Based on the economic forecast that can be made today, we advise against measures that would further stimulate private consumption in 2011. It is expected to increase rapidly all the same and lead to a substantial increase in employment in the private service sector.

How to best design fiscal policy in the next few years is related to the appropriate balance between fiscal and monetary policy. In countries with serious fiscal problems, fiscal policy will probably have to be tightened before resource utilisation has reached a satisfactory level. If so, an expansive monetary policy may be needed to compensate, particularly in countries that are still experiencing problems in the financial sector and where there has been a large fall in property prices. However, the Swedish situation is different. There has been no permanent fall in housing prices. We are concerned that low interest rates that last too long will lead to excessive borrowing and too high housing prices thus contributing to future imbalances. This may be an argument for the Riksbank to begin raising the repo rate more rapidly than justified by the medium-term inflation forecast alone. Such a policy would, however, have a negative impact on demand, which, in that case, would probably need to be countered by keeping fiscal policy expansive longer than would otherwise have been justified.

There may thus be arguments for another stabilisation policy mix in Sweden, with a tighter monetary policy and a more expansive fiscal policy than in most other countries. At the same time it is not obvious how to get an appropriate balance between monetary and fiscal policy in a system in which – for good reasons – the former is decided by an independent central bank and the latter by the Government.

Surplus target to be statutory

Since the end of the 1990s, the *surplus target* has been a key element of the fiscal framework. This target states that general government net lending, i.e., the difference between revenue and expenditure, is to be one per cent of GDP over a business cycle.

The Ministry of Finance has, under the Government's current term of office, conducted a review of the surplus target leading to a report published earlier this year. On the basis of this report, the Government now proposes to make the formulation of a surplus target statutory. We welcome this proposal which strengthens the target's position.

The surplus target is an *intermediate target* aimed at making it easier to achieve overall, more fundamental goals. The most important of these aims stated by both the current and the previous governments are:

- Long-term sustainable public finances
- Economic efficiency
- Equitable distribution of resources between generations
- Room for manoeuvre in stabilisation policy in economic downturns

These general goals need not be consistent with each other. Instead they may justify different levels of the surplus target. We have therefore previously criticised the Government for not having made sufficiently clear the importance attached to different fundamental goals.

The Government's discussion of the motives for the surplus target has become more transparent in the Spring Fiscal Policy Bill for 2010. The Government makes it clear that sustainability is not actually an objective but a restriction with which it must comply. It also makes it clear that considerable importance should be attached to the stabilisation policy motive, which may be natural, given experience from the crisis.

Uncertain how the cost of rising life expectancy and higher quality of welfare services will be financed

Another important clarification in the Spring Fiscal Policy Bill is that the budget surplus (*pre-funding* by current generations) will not be used to cover future costs that may arise because later generations will live longer than current generations and may demand welfare services of higher quality than those available today. This clarification is in line with our argument in last year's report. It has not previously been made by the Government.

It is, however, a major shortcoming of the Spring Fiscal Policy Bill that it makes no mention of what *mechanisms* are needed to ensure funding of future expenditure increases as a result of longer life expectancy and/or increased demand for higher quality of welfare services. It is unlikely that the private financial incentives built into the pension system will lead to a sufficiently large rise in the labour market exit age. In our opinion, there need to be regular reviews of the pension rules with a view to ensuring that the actual retirement age does indeed increase in line with average life expectancy. How this is to be done ought to be one of the main topics of discussion, particularly during an election year. It is unfortunate from a legitimacy perspective that there is no broad public debate on the future funding of welfare. Such a debate will not take place if the political parties systematically avoid it.

Muddled and illogical follow-up of the surplus target

In recent years, the Government has used five different indicators to evaluate whether the surplus target of one per cent of GDP *over a business cycle* has been achieved. Calculations have been made for (i) a backward-looking average for actual net lending since 2000; (ii) a moving and partially forward-looking average for actual net lending (the *seven-year indicator* based on historical values for the three previous years and forecasts for the current year and the coming three years); (iii) structural net lending for the current year; (iv) a cyclically adjusted backward-looking average; and (v) a cyclically adjusted seven-year indicator.

The different indicators reflect fundamentally different targets. If a backward-looking indicator is used, there is in principle a target 'with memory', where previous deviations are to be compensated for. With an indicator for the current year, there is no 'memory' and there does not need to be any compensation for previous deviations. The partially forward-looking seven-year indicator is something in between. It is to be fulfilled *in advance* but does not necessarily have to be fulfilled *afterwards*. The number of indicators with various meanings entails a basic lack of clarity about what the surplus target actually means.

One basic problem with the Government's choice of indicators is that it mixes a backward-looking perspective aimed at *evaluating* whether the surplus target *has* been met with a forward-looking perspective, which amounts to a *planning tool* for meeting the target in the future.

We think that the rolling backward-looking ten-year indicator that has been proposed – and employed for the first time – in the Spring Fiscal Policy Bill should be used as an indicator of how the surplus target has been met. This should be done without any cyclical adjustment. But the previous cyclical situation should of course be a key factor in assessing whether deviating from the surplus target was justified in the previous ten-year period. A forward-looking indicator should be used to assess what will be required of fiscal policy in the future in order to meet the surplus target in the rolling ten-year period, i.e., in order to estimate the room for reform or the need for consolidation measures, just as it is now.

We would thus prefer the use of *two* indicators: a rolling backward-looking indicator and a rolling forward-looking indicator. This would increase clarity in monitoring the surplus target.

We share the Government's opinion that mechanical adjustments to deviations from the target should be avoided. However, the importance of the surplus target could be stressed by stipulating that if deviations from the target occur above a certain magnitude (for example, 0.5 percentage points) in accordance with *one* of the two indicators, then the Government will be obliged in a *special communication to the Riksdag* to account for the causes and what remedy – if any – is intended. In such a communication, the Government should also state if in its opinion the deviation instigates a need to revise the surplus target in order to compensate for the previous development. Such provisions could be introduced in a *code of conduct* for fiscal policy of the type that, according to the Spring Fiscal Policy Bill, the Government plans to draw up.

Time for the Ministry of Finance to improve reporting

In our earlier reports, we have asked for improvements in the Budget Bill and the Spring Fiscal Policy Bill's reporting of various points. These primarily concern labour market programmes, public sector capital stock and investment, public sector total net worth and generational accounting to shed more light on how the public sector affects income distribution between different generations. In our view the Riksdag has not been provided with a satisfactory basis for decision-making on these points.

Very little has happened in this area thus far. However, we welcome the Government's statement in the Spring Fiscal Policy Bill that work will begin on improving public sector reporting of its real assets and investments. At the same time, we are critical of the long time it has taken to get started on this work.

Furthermore, it is surprising that the Ministry of Finance and the National Institute of Economic Research report very different figures for general government financial net worth. According to the Spring Fiscal Policy Bill, financial net worth amounted to not quite 16 per cent of GDP, whereas the March Report of the National Institute of Economic Research reported a financial net worth of 25.8 per cent. This is a difference of about 10 per cent of GDP, or about

SEK 300 billion. The difference is mainly because the National Institute of Economic Research, unlike the Ministry of Finance, follows the financial accounts and reports accrued, but not yet paid, taxes and charges as assets. It is unsatisfactory that the Government and the National Institute of Economic Research report such different figures without any comment about how the accounting is done.

The Government's budget bills and the National Institute of Economic Research's reports also account for public sector revenue and expenditure in such different ways that it requires considerable work to understand what explains the difference in the forecasts for the development of the public finances. It would be desirable for the Government in its budget bills to explain why the forecasts differ.

Stronger labour market development than expected

Previous experience of deep economic downturns in both Sweden and other countries indicates that there is a risk that what is originally cyclical unemployment will turn into persistent structural (equilibrium) unemployment. Even at best, it may after major reductions in employment take a long time – a decade or more – before employment regains its previous level. There are some indications that this risk is less now than it was in connection with the crisis in Sweden in the 1990s. In the current crisis, employment has declined less in relation to output than it did in previous downturns. A likely cause is that the decline in output has been concentrated in manufacturing, while the private service sector has fared better. Large reductions in employment in the public sector have also been avoided. The changes in the unemployment insurance and the earned income tax credit may also be expected to counter the rise in the equilibrium rate of unemployment since they strengthen the incentives to work.

The Government's employment policy has targeted groups with a weak foothold in the labour market. There is therefore reason to scrutinise developments for these groups more closely. This is done in the Spring Fiscal Policy Bill, but the scrutiny is quite superficial as there are no comparisons with previous economic downturns. The principal conclusions from such an extended analysis are:

- Compared to the population as a whole, young people have fared about as poorly in the current crisis as in previous economic downturns.
- Relative employment growth for people born outside Europe has, however, been considerably better than it was in previous downturns.
- The older age group has fared somewhat better compared to the population as a whole in this crisis than in the 1990s crisis, but somewhat worse than in the downturn in the early 2000s.
- Relative employment growth for people without an upper secondary education has been considerably worse than in the 1990s crisis.

It is thus a mixed picture. The improvement for immigrants born outside Europe in relation to developments for the population as a whole reduces the risk of unemployment persistence. The same is true of developments for older workers, since when they experience unemployment, they tend to disappear from the labour force to a greater extent than younger workers. Developments for low-skilled people, are, however, a cause for concern. It is also worth noting that there has been a significant drop in employment among young people during this economic downturn even though one of the Government's major initiatives has been the reduction of social contributions for young people. It seems to be easier for young people than for others, however, to re-enter the labour market after an unemployment spell. From this perspective, it may thus be worse if older workers become unemployed than if younger workers do.

A key objective of the Government's employment policy is to avoid long spells of unemployment for those who lose their jobs. In these circumstances, the absence of easily accessible statistics on the distribution between short- and long-term unemployment is remarkable. The Swedish Public Employment Service no longer reports current statistics on long-term registrations at the Employment Service. Statistics Sweden cannot supply statistics on long-term unemployment that are comparable over time. This makes in-depth analyses of long-term registrations at the Public Employment Service and of long-term unemployment impossible. This is unacceptable. It is not clear to us how the responsibility for the lack of statistics should be apportioned among the Government, the Public Employment Service and Statistics Sweden. But it must be possible for the Government to direct its authorities to see that there are basic statistics that can be used to make a satisfactory analysis of how well one of its most important targets is met.

Earned income tax credit probably effective but the Government does not explain why

The earned income tax credit is in the Government's opinion "the single most important reform" to "get more people working and reduce exclusion". The total gross cost in the form of reduced tax revenue (without taking into account the likely positive effects on employment and thus on the tax base) is about SEK 70 billion.

The debate on the earned income tax credit is usually conducted as an isolated Swedish debate without any international perspective. This tax credit is, however, very common internationally, even though the cost of the credit is higher in Sweden than in other countries. There is an earned income tax credit in the majority of OECD countries: 17 out of 30 countries. The Swedish earned income tax credit differs, however, from corresponding credits in most other countries in so far as it is paid to everyone who works regardless of how high their earned income is (even though it gives a larger percentage increase in income to low-wage earners than to high-wage earners). Only two other countries, Denmark and the Netherlands, have the same design.

In other countries, the credit is phased out from a specified earned income threshold to eventually end altogether. Such a construction would, however, hardly be defensible in Sweden. The reason is that a decrease in the credit would increase the already high marginal taxes even more for those in the phase-out interval and thus provide strong incentives for them to reduce the number of hours worked.

A rational political discussion of the earned income tax credit presupposes clarity on how it is intended to work. Here there is reason to be critical of the Government's failure to explain the mechanisms. It points out that the credit increases the return to work and can therefore be expected to lead to higher labour force participation. However, the Government has failed to explain why the higher supply of labour will correspond to a higher demand for labour so that those who want to have a job will also get one. The obvious mechanism is that a larger labour supply in the long run acts to restrain wages *before tax*, and thus firms' wage costs, hence making it more profitable for firms to hire. At the same time, *after-tax* wages may be expected to rise more than would otherwise have been the case. With the combination of lower wage increases before tax and higher wage increases after tax, both employers and wage earners gain from the reform. This is possible because the resources available increase if more people work.

Extensive empirical research from other countries indicates that the earned income tax credit has significant positive effects on employment. Many of these studies have compared employment growth for groups that have received earned income tax credits with that for groups who have not. Such comparisons cannot be made in Sweden since everyone with earned income gets the earned income tax credit. Therefore, one is instead obliged to base one's calculations on statistically estimated relationships between hours worked and after-tax wages. On the basis of such calculations, the Ministry of Finance has estimated the long-term effect on the number of people in work at about 80 000 people.

The Ministry of Finance estimates are well in line with the 'best practice' identified in the research in this area. At the same time, it is obvious that no consideration has been given to a number of effects that would be expected to be important, but which are difficult to estimate. It is difficult to say whether this leads to over or under estimation of the effects. But it would be desirable for the Government to be more explicit about the large uncertainty in the estimates.

Employment growth in recent years says very little about the long-term effects of the earned income tax credit. The credit would mainly be expected to affect equilibrium employment, that is, average employment over the business cycle. In the short run, employment developments are mainly determined by cyclical swings in aggregate demand. Possible effects of the earned income tax credit in the last two years have most likely been overwhelmed by recent years' dramatic cyclical developments.

Taxing earned income and pensions differently is justified if the aim is to increase employment

There has been an intensive debate on whether it is 'unjust' that, as a result of the earned income tax credit, the gainfully employed and pensioners are taxed differently. What income distribution considerations should be taken into account in tax policy is a matter of values.

The chief aim of the earned income tax credit stated by the Government is employment policy, not income distribution policy. On this basis, it is logical to have lower taxes on earned income than on pensions. In principle, an earned income tax credit that also covers that part of pension income accrued from earned income would maintain the incentives to work that the credit now engenders. In practice, designing such a credit, however, appears very difficult.

In discussions of income distribution, it is important to distinguish between, on one hand, redistributions of life incomes between *persons* and, on the other hand, redistribution of a person's life income between different *parts of the life cycle*. Distribution concerns are likely to be mainly tied to the first type of redistribution. The earned income tax credit gives rise to such interpersonal redistributions because today's pensioners did not receive any earned income tax credit when they were working. These redistribution effects will gradually diminish if the current earned income tax credit becomes permanent: ultimately everyone who retires will have benefited from the credit while they worked.

One way of avoiding interpersonal income redistributions is to compensate the retired generations who have not received – or only receive in part – the earned income tax credit by targeted tax cuts. The tax cuts for people over 65 introduced by the Government this year (about SEK 3.5 billion) and announced for next year (about SEK 5 billion) – could be viewed as such compensation. But in this case, the tax cuts should not be designed so that everyone over a certain age gets permanently lower taxes. Instead, the cuts should be linked to year of birth. The cuts should be made smaller the later the people who are retiring were born, since later generations will to an increasing extent benefit from the earned income tax credit while they work. This would involve an automatic phase-out of the tax reduction over time. There would be some rational basis for a tax reform like this. But in practice it would hardly do to have different tax rules for each age cohort. Instead, it would be reasonable to differentiate between quite broad age classes, which would probably instigate new arguments about fairness.

Stronger arguments for household services tax credit than for RMI tax credit

During its term of office, the Government has introduced tax reductions for household-related services, which include cleaning, maintenance and laundry (household services) and for repairs, maintenance and improvements (RMI work). The explicit aim of the reductions is to reduce the distortions that the tax system may give rise to. High taxes on services that households can perform themselves or services that relatively easily move to the unregistered sector can create substantial social efficiency losses. In earlier reports, we have expressed the opinion that tax reductions for services that are close substitutes for doing the work oneself lead to social efficiency gains. This points to stronger arguments for tax relief for household-related services than for repairs, maintenance and improvements work, since the latter requires professional skills to a greater extent.

The timing of the introduction of the RMI tax credit was cyclically motivated. A permanent credit is, however, a less effective stabilisation policy than a temporary credit, since it does not create incentives to have the work done earlier. The gross cost of the RMI tax credit has also been much higher than what the Government forecast. In our opinion, there are grounds for re-examining whether the RMI tax credit should be retained when the business cycle turns upwards.

Too much coaching and too little labour market training

To prevent unemployment from persisting even after the business cycle has turned upwards, the Government has revised its labour market policy. More resources are now being directed at people with short unemployment spells. The focus is on coaching measures and various types of work practice. One change in 2010 is a new activation measure primarily in the public sector, *Lyft* (an initiative for work experience for the unemployed), which can be offered to both the short-term and long-term unemployed.

The number of participants in various labour market programmes has increased in 2009. Programme participation has, however, not increased at the same pace as unemployment. If one assumes that some job search activities do not in practice have very much content, the number of participants in active programmes is substantially lower today than earlier. Programme volumes should be considerably less than they were during the 1990s crisis for efficiency reasons, but there is nevertheless reason to question whether labour market programmes (apart from job search activities) have become too small.

Job search activities accounted for more than half of the programme initiatives in 2009. There are good reasons for focusing more on job search activities. But coaching initiatives have probably been too large in an economic situation with few job vacancies. High search intensity has in all likelihood a small effect on the chance of getting a job in a deep economic downturn.

When unemployment is largely due to low demand, the policy should to a greater extent focus on recruitment incentives for the long-term unemployed. The doubling of subsidies for new start jobs introduced in 2009 has led to more such jobs than we expected. We also take a positive view of the Spring Fiscal Policy Bill's proposal for a temporarily reduced qualification period for new start jobs for older workers since there are fewer job opportunities for unemployed older workers than for younger ones.

It is also useful in the prevailing economic situation to expand work experience places and labour market training since there are smaller locking-in effects than there would be otherwise. We therefore take a positive view of the initiatives for work experience places but we think that the budgeted volumes are completely unrealistic. We are critical of the Government's attempt to instruct the public authorities to supply as many as 20 000 places in *Lyft*. With so many work experience places, they will be of dubious quality.

There is good reason for continuing to criticise the low level of labour market training. The volumes were altogether too high during the 1990s crisis, but they seem to be unreasonably low now. Experience over the past decade shows that labour market training can be run effectively. We take a positive view of the initiatives for adult vocational training in the regular education system but it should be seen as a supplement, not as a substitute, for labour market training.

The number of participants in the job and development guarantee is growing rapidly. The Public Employment Service has had continued difficulty finding work experience places. The Public Employment Service has many participants per officer, insufficient time for contacts with employers and difficulty offering full-time activities. These problems will probably increase when the number of participants grows in the next few years. It will be difficult to maintain a good quality.

To sum up, in our opinion the labour market policy pursued during the current crisis has been substantially better designed than the policy during the 1990s crisis. The policy has benefited from lessons learned from previous experience. At the same time, we think that the Government has let the pendulum swing too far in the opposite direction in a number of areas: there has been too much emphasis on job search activities and coaching while other programmes, labour market training in particular, have been too small.

Good to have private providers in labour market policy but better evaluation needed

We take a positive view of the ambitions to make more use of *private providers* as a way to increase effectiveness in labour market policy. However, experience from other countries is mixed. When the services procured are complex, there is a need for well-thought-out regulation, expert procurement and proper evaluations.

The Government's target is for a third of the participants in the job guarantee for young people and in Phases 1-2 of the job and development guarantee to be offered services from private providers. With the rapid expansion now underway in both of these guarantee programmes, we doubt that the market will be able to grow as rapidly and maintain good quality services.

The cooperation with private providers must be evaluated on an ongoing basis. However, with the limited information currently being collected, this would appear to be difficult. The lack of well-thought-out procedures for evaluating individual providers is a serious shortcoming. This goes both for the Public Employment Service's ability in future procurements to choose good suppliers and for jobseekers' choice of personal coach. It is not enough to compare the Public Employment Service with the private providers on average. Instead there need to be qualified evaluations of individual private providers' results. It is hard to escape the impression that the Government was in such a hurry to privatise parts of labour market policy that it was not possible to find the time to develop the necessary evaluation systems.

Bouquets – but also brickbats – for the sickness insurance reforms

The Government should be commended for tackling a difficult problem by reforming sickness insurance. The reforms have most likely been an important reason for the continuation of the trend begun in 2003 showing a decline in sickness absence. There is research to support that the reforms both strengthen the incentives to work and increase the opportunities to work. The rehabilitation chain appears to have been put into practice as intended. The transition to the Public Employment Service appears to be working relatively smoothly.

It goes without saying that the large problems that existed in the sickness insurance cannot be addressed without making mistakes. But in our opinion there have been too many mistakes. The Government should be criticised for implementing the reforms too hastily and in some respects carelessly and for its treatment of people on long-term sick leave whose benefits have expired.

It presumably would have been wise to distinguish between *stock* and *flow* in sickness absence. An amnesty could have been granted to those who were already on sickness absence or early retirement on 1 July 2008 (the stock) when the new rules were introduced and let them only apply to the new inflow. Proceeding in this way would have made it possible to try out the rules on a smaller scale.

The Government has had to back away from many reform proposals. In other cases, the content has been changed or exceptions introduced at a late stage. It is obviously particularly important that reform proposals on such sensitive issues as restrictions in the social security systems on which many people are dependent are well prepared.

The Government's sickness insurance reforms can be criticised for inferior transparency. Because the rules system is complicated and there are many exceptions in the rehabilitation chain, the different actors in the sickness absence process, including the Swedish Social Insurance Administration, have had difficulty interpreting the rules. This situation has gradually worsened after the latest changes in winter 2009/2010.

The increase in early retirement among young people is alarming and there need to be thorough analyses of the reasons behind it. Possible links to earlier school reforms that made it more difficult to complete a school-leaving certificate and increased the theoretical element in education need to be examined. From this perspective, the Government's reforms in the direction of more practical upper secondary programmes are probably valuable.

For older people, the opposite problem may apply: namely that early retirement is too seldom granted. We would like to caution that the criteria for early retirement may have become too strict. The requirement for *permanently* impaired work capacity is quite severe. It is unreasonable to think that everyone who does not meet the criteria can get a job in the regular labour market.

Risk of overexpansion in regular education in an economic downturn

Increasing the number of places in regular education is one of the ways the Government has chosen to tackle the economic downturn. For this year and the next, the 2010 Budget Bill includes increased appropriations for universities and colleges equivalent to 10 000 places a year, 3 000 more places a year at vocational colleges and initiatives in adult vocational training corresponding to 10 000 places each year. There are some other initiatives in the Spring Fiscal Policy Bill.

In a difficult labour market situation, it becomes more attractive to get an education. The expected income that the individual has to forgo while studying is smaller and the risk that long-term unemployment will have a negative impact on the individual's human capital in future is particularly high in such a situation.

Private demand for education can deviate from what is desirable from a social efficiency point of view for several reasons. This is true also in normal times. Given that the volume of education is socially efficient then, it is appropriate to increase the number of places in an economic downturn when the return to education increases. There is thus a theoretical basis for varying education volumes over the business cycle.

But there are also reasons for not satisfying the whole increase in demand for education in a downturn by providing more places. One reason is that a rapid expansion in education volumes may lead to lower quality education, for example, because of difficulties hiring enough qualified staff. It is also possible that individuals *overreact* to the risk of unemployment and – from a social efficiency perspective – demand too much education because it provides a livelihood when they cannot get one from unemployment insurance benefits. Removing the study condition in the unemployment insurance in 2007 is a reform that may have caused students to extend their studies in order to get student aid to support themselves.

There are some indications that higher education has expanded more during this economic downturn than according to previous patterns. It is difficult on the basis of current knowledge to form an opinion on whether the size of the expansion has been appropriate. It has taken place without any satisfactory knowledge basis. We would like to caution against the risk of excessive expansion of regular education in economic downturns. There is a great need for research on the effectiveness of using regular education as a cyclical policy instrument.

Role of supplementary unemployment insurance is unclear

The current Government's most important goal is to increase employment in the long run. To achieve this, the Government has carried out reforms that make it more worthwhile to work compared to being unemployed.

On one hand, there is ample evidence indicating that reduced benefit levels in the unemployment insurance tend to reduce unemployment. On the other hand, the result is less income protection in the event of unemployment. What the trade-off should be between employment and insurance is a matter of political value judgements. But a rational trade-off presumes a good knowledge of how different reforms affect income protection in the event of unemployment.

There has been a great deal of uncertainty about what income protection in the event of unemployment is offered by the various supplementary insurance schemes provided in collective agreements and by trade unions. We have had a survey conducted which included questions about the use of this supplementary insurance. According to the survey, surprisingly few of the unemployed receive compensation from supplementary insurance.

In the survey, we also asked questions about the unemployed's reservation wage, i.e., the lowest wage for which one is prepared to work. Our analysis indicates that the benefit levels after tax affect reservation wages even though the effects are relatively modest. The benefit level has a greater effect on the reservation wage for the long-term unemployed than for the short-term unemployed. This finding is an argument that decreasing unemployment benefits as the unemployment spell lengthens, as in the current system, may provide an effective balance between income protection and incentives to work.