

Swedish Fiscal Policy

Fiscal Policy Council Report 2018

The Swedish Fiscal Policy Council is a Government agency, whose remit is to conduct an independent evaluation of the Government's fiscal policy. The Council fulfils its tasks primarily through the publication of the report Swedish Fiscal Policy, which is presented to the Government once a year. The report is used by the Riksdag as a basis for its evaluation of the Government's policy. The Council also arranges conferences. In the series 'Studier i finanspolitik' (Studies in fiscal policy), it publishes in-depth studies of different aspects of fiscal policy.

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Foreword to the English translation

The 2018 report of the Swedish Fiscal Policy Council was published in Swedish on May 14, 2018. The translation into English was conducted by Semantix AB in collaboration with the council secretariat under the supervision of Joakim Sonnegård, Head of Agency.

Stockholm, September 21, 2018

Harry Flam
Chairman of the Council

Foreword

The Fiscal Policy Council is tasked with monitoring and analysing fiscal policy. The Council also aims to promote more public debate in society about economic policy.

The Council consists of six members. Since the previous report in May 2017, the appointments of Hilde C. Bjørnland and Yvonne Gustafsson have come to an end. Kari Lotsberg and Ragnar Torvik are new members of the Council.

The Council is assisted by a secretariat consisting of Joakim Sonnegård (Head of Agency), Niklas Frank (Deputy Head of Agency and Senior Economist), Christina Håkanson (Senior Economist), Hannes Jägerstedt (Economist) and Charlotte Sandberg Gavatin (Head of Administration).

This is the Council's eleventh report. The analytical work was completed on 26 April. The Council has commissioned two background papers. They will be published in the Council's publication series, *Studier i finanspolitik* (Studies in fiscal policy):

1. Eric M. Leeper – Sweden's fiscal framework and monetary policy.
2. Elin Ryner och Markus Sigonius – Påverkan på offentliga finanserna vid en avveckling av vidareutlåningen till Riksbanken [The impact on public finances in the event of termination of on-lending to the Riksbank].

We have received many valuable comments. We would particularly like to thank all those who have presented reports at Council meetings: Karolina Holmberg, Katinka Hort, Anna-Malin Karlsson, Eric M. Leeper, Svante Mandell, Ingvar Mattson, Kristian Nilsson, Per Olof Robling, Elin Ryner, Hans Sacklén, Jan Sand, Markus Sigonius and Simon Wren-Lewis.

Our dialogue with colleagues at the National Institute of Economic Research is valuable in our work. Discussions with Karolina Holmberg, Svante Mandell, Kristian Nilsson, Elin Ryner and Markus Sigonius throughout the year were especially helpful.

Special thanks go to Eric M. Leeper, Elin Ryner and Markus Sigonius for this year's background papers. Finally, we would like to join with the whole of the secretariat in thanking Susanna Aggeborn, Thomas Bergman, Karl Bergstrand, Tora Bäckman, Lars Calmfors, David Domeij, Jesper Hansson, John Hassler, Marie Hyllander, Erik Höglén, Lars Jonung, Albin Kainelainen, Nils Landén Helmbold, Philip Löf, Johanna Modigsson, Marcus Mossfeldt, Mats Persson, Karine Raoufina, Jesper Roine, Joakim Skalin, Hedvig Westphal, Marcus Widén, Milena Zart, Johan Åhman and Ann-Sofie Öberg for their interesting views and constructive comments.

Stockholm, 2 May 2018

Harry Flam
Chairman

Kari Lotsberg
Deputy Chair

Peter Englund

Cecilia Hermansson

Bertil Holmlund

Ragnar Torvik

Abbreviations

AKU	Labour Force Surveys (Statistics Sweden)
BP	Budget Bill
GDP	Gross Domestic Product
ECB	European Central Bank
ESA	European System of National and Regional Accounts
ESV	Ekonomistyrningsverket (Swedish National Financial Management Authority)
FASIT	Distribution analysis system for incomes and transfers
FI	Finansinspektionen (Swedish Financial Supervisory Authority)
IMF	International Monetary Fund
ISK	Investment Savings Account
JUG	Job and Development Guarantee Programme
NIER	National Institute of Economic Research
CPIF	Consumer Price Index with a fixed interest rate
NAIRU	Non-accelerating inflation rate of unemployment
NAWRU	Non-accelerating wage rate of unemployment
OECD	Organisation for Economic Co-operation and Development
RiR	Riksrevisionen (Swedish National Audit Office)
SCB	Statistics Sweden
VP	Spring Fiscal Policy Bill
WTO	World Trade Organization
ÅP	Old-age pension system

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The Fiscal Policy Council's remit

The Fiscal Policy Council has been instructed to review and evaluate the extent to which the fiscal and economic policy objectives proposed by the Government and decided by the Riksdag are being achieved, and thus to contribute to more transparency and clarity about the aims and effectiveness of economic policy.¹

The Council shall, with the Spring Fiscal Policy Bill and the Budget Bill as a basis, assess whether fiscal policy is consistent with:

1. long-term sustainable public finances, and
2. budgetary targets, particularly the surplus target and the expenditure ceiling, but also the debt anchor and, where required, the balanced budget requirement for local authorities.

The Council, with the Spring Fiscal Policy Bill and the Budget Bill as its basis, shall also

1. assess whether the fiscal stance is consistent with the cyclical position of the economy, and
2. evaluate the Government's forecasts of economic development and reports to the Riksdag on the public finances and the costs of reform proposals. This evaluation should comply with Article 4(6) of European Council Directive 2011/85/EU of 8 November 2011, in its original wording.

The Council is also tasked with reviewing and assessing whether fiscal policy is in line with healthy long-term sustainable growth and leads to long-term sustainable high employment, examining the clarity of the Spring Fiscal Policy Bill and the Budget Bill, particularly with respect to the stated basis for economic policy and the reasons for proposed measures, and analysing the effects of fiscal policy on the distribution of welfare in the short and long term.

The Council also works to stimulate more public debate on economic policy.

¹ SFS 2011:446, SFS 2016:1088 and SFS 2017:1316.

The fiscal policy framework

The fiscal policy framework consists of the fundamental principles that fiscal policy is to follow to be sustainable in the long term.¹ Some of these principles are governed by law, while others follow practice. The budgetary targets, i.e., the surplus target, the debt anchor, the expenditure ceiling and the balanced budget requirement for local authorities, constitute, together with a restrictive national budget process, external monitoring and transparency, the core components of the fiscal policy framework.

Under the Budget Act, the Government is required to present a proposed target for public sector net lending, a surplus target. The Riksdag has determined that the surplus target as of 2019 shall amount to 1/3 per cent of GDP on average over a business cycle. Until then, the current target level of 1 per cent of GDP will apply. In the event of an established deviation from the surplus target, the Government shall provide instruction as regards a reversal towards the target. The plan for the reversal is to be time-bound and is usually initiated during the following year, and the speed of the reversal to the target shall take the economic situation into account.

Under the Budget Act, the Government has to propose an expenditure ceiling for the third year ahead in the Budget Bill. The Riksdag sets the expenditure ceiling. Under the expenditure ceiling, there is customarily a budget margin of a specified size. This is mainly there to act as a buffer if expenditure develops in an unexpected way.

The expenditure ceiling is the overarching restriction in the budget process. In the budget process, priorities are set for different expenditure types and expenditure increases are considered in the light of a predetermined total fiscal space provided by the expenditure ceiling and the surplus target. In principle, expenditure increases within an expenditure area have to be covered by proposals for expenditure reductions in the same area.

As a supplement to the surplus target, a debt anchor for the public sector's consolidated gross debt will also be introduced from 2019. The debt anchor is not an operational target but rather a benchmark

¹ This summary is based on the so-called framework document, Skr. 2017/18:207.

for the desired debt level in the medium term, and the level is set at 35 per cent of GDP.

Since 2000 there has been a balanced budget requirement in effect in the local government sector. The balanced budget requirement states that each municipality and county council must plan for a balanced budget, if there are no exceptional reasons.

The surplus target and debt anchor are to be stable over longer periods of time, but at the same time be able to be reviewed in the event of, for example, changing assessments of demographics or debt developments. In order to avoid changing the targets in such a way that their credibility is reduced, changes should be made in a predictable manner and with as broad political support as possible. Target levels should therefore be reviewed every eight years, at the end of each term.

Summary

The main task of the Fiscal Policy Council is to review and evaluate the extent to which fiscal and economic policy objectives are being achieved. Our principal conclusions in this year's report are as follows:

Economic conditions and stabilisation policy

1. The Swedish economy has been strong for several years and this trend appears to continue in 2018–2019, even if a certain downturn is to be expected. Domestic factors, especially housing investments and public consumption, have had a positive effect on growth. Due to the upturn in the global economy, the activity level in Sweden is likely to be maintained for a while longer.
2. At the same time, there are imminent risks to the economic trend. Housing investments have already started to decline. High asset prices and high levels of debt make many businesses and households vulnerable. There are also a number of structural problems that risk inhibiting growth in the long term, such as an ageing population and weak productivity development.
3. The active fiscal policy over the last few years has been procyclical; the structural net lending has decreased despite the current economic upturn. For this reason, the fiscal policy cannot be considered well-balanced in relation to the economic trend. The Government has not sufficiently prioritised the surplus target when it comes to adapting its fiscal policy to the economy. The fiscal policy should be more restrictive, partly to reduce the risk of overheating, and partly to increase the future scope of economic stabilisation measures.
4. Unlike the Government, the Fiscal Policy Council is of the opinion that there is currently no reason for the fiscal policy to support the monetary policy. Inflation is close to the target and the use of resources is high.

The surplus target and the expenditure ceiling

5. The surplus target is being changed from 1 to 1/3 per cent of GDP over one economic cycle as of 2019. Retrospectively, the current target has not been attained. Nor has the surplus reached an average of 1/3 per cent of GDP in the last eight years.
6. To assess whether the fiscal policy is in line with the surplus target looking ahead, the Council uses the structural savings in the current year and the next year. The Council is of the opinion that there is no significant deviation from either the current surplus target or the new target. The Council consequently deems the fiscal policy to be reconciled with the surplus target.
7. However, the Government appears to be optimistic in its estimation of structural savings: its calculation assumes that equilibrium unemployment is lower and the potential GDP higher than what is assessed by other forecasters.
8. The expenditure ceilings for 2018–2020 are high enough to allow for significant increases in expenditure. The scope allowed by the expenditure ceiling is significantly larger than the expenditure allowed within the surplus target according to current forecasts. If the scope allowed by the expenditure ceiling is used, government revenue needs to be higher, or the expenditure ceiling loses its steering function. We believe that the Government should provide more detailed arguments regarding its views on the desirable expenditure and revenue development over three years as part of the guidelines for economic and budgetary policy.

Principles of the stabilisation policy

9. In spring 2018, the Government presented a new framework document, which unlike earlier documents does not contain an account of the principles for the division of responsibilities for the stabilisation policy. A clarification of the division of responsibilities between fiscal and monetary policy should be included in the framework document.

10. The division between fiscal and monetary policy that has provided the foundation of the fiscal policy framework since the mid-1990s should not be revised in our opinion. The main responsibility for the stabilisation policy lies with the Riksbank. In normal circumstances, the fiscal policy contributes to the stabilisation policy through automatic stabilisers. In exceptional cases the monetary policy may require active support from the fiscal policy, for example, when lowering the Riksbank's policy rate is no longer a sufficient or possible measure.

The debt anchor and long-term sustainable public finances

11. The Council makes the assessment that the public finances are sustainable in the long term. The estimations made by the National Institute of Economic Research (NIER) regarding the sustainability of the public finances up until 2030 indicate small risks of an unsustainable development.
12. Our assessment is that the gross public debt will stay within the target range for the debt anchor until the next review in eight years.
13. If the Riksbank discontinues its borrowing to reinforce the international reserves, which is a possibility, the gross debt ratio will decrease by around 5 percentage points (without affecting net debt). This should then lead to a technical adjustment of the debt anchor.
14. The Council views the Pension Group's agreement as a welcome addition. It is in line with the Council's previously stated opinion that the retirement age needs to be gradually raised for the public finances to be sustainable in the long term and for pensions to be at a reasonable level.

Unemployment and employment

15. The Council is of the opinion that several labour policy measures in the Budget Bill for 2018 are appropriate. However, we deem the effects on the equilibrium unemployment to be small and that extensive efforts remain to lower labour market thresholds, improve matching and reduce the discrepancies between native-born and foreign-born individuals.

16. Our assessment is that the Government will not attain its aim of Sweden having the lowest unemployment rate within the EU by 2020. The target is not appropriate. The Government should, as previously proposed by the Council, reformulate its unemployment target into separate targets closely linked to the problems evident on the domestic labour market. This relates in particular to the labour market prospects of those with no upper secondary education, individuals born outside of Europe and newly arrived migrants.
17. Employment is still the highest in Europe. It is a positive point that the employment rate has risen for a number of years, in particular for foreign-born individuals. The high level of immigration in 2015–2016 means that a larger part of the labour force has a weak connection to the labour market. This places large demands on the labour market policy in the coming period.
18. For many, temporary and subsidised employment will not be sufficient for firm establishment in the labour market. The Council therefore sees a continued need for the social partners to also be open to the idea of regular low-skilled jobs.
19. In the long term, the Adult Education Initiative can contribute both to reinforcing the employment prospects of those with a weak connection to the labour market and to addressing the current shortage of labour. There is currently no comprehensive follow-up of the measures within the Initiative. The Council would like to see such a follow-up.

Income distribution and taxation of household investment income

20. The income spread has widened in the last decades. The main explanation is that investment income has increased and become more concentrated to the high income brackets. Another explanation is that transfer payments have not increased at the same rate as general income. Structural changes have also contributed, such as an increased proportion of single households, an increased proportion of elderly in the population and an altered employment composition.

21. Following the 1991 tax reform, a number of changes have been implemented in terms of capital taxation: the inheritance, wealth and gift taxes have been abolished; the property tax has been replaced by a property charge; investment savings accounts have been introduced; and changes in the 3:12 regulations have increased the opportunities to take out earnings in the form of dividends from close companies. All in all, these reforms have entailed a lower average taxation on investment income, greater differences between the taxation of various forms of investment income and a greater asymmetry in relation to deduction rates. These changes have primarily benefited high-income households.
22. The concept of investment savings accounts (ISK) was introduced in 2012 with the aim of stimulating the households' direct ownership of funds and shares. The taxation has been considered highly beneficial and was raised from 2018. However, ISK investments entail a greater risk for the holder compared with investments subject to conventional taxation. With this in mind, the Council deems the tax benefit to be small.
23. While the current taxation on property was lowered in 2007, the taxation on realised capital gains on property was tightened. This has likely contributed to reduced mobility on the housing market. A future tax reform should be formulated so that property taxes to a greater extent are levied on a current basis in relation to the value of the property and to a lesser extent based on the realised capital gain.

1 The economic situation

The purpose of the chapter is to convey a picture of the economic situation and the growth conditions in Sweden and the rest of the world. The Council discusses and evaluates the Government's economic policy in the light of this in subsequent chapters.

In order to conduct a fair assessment of the Government's adopted and announced policy, the economic situation prevailing when the budget bill was presented must be taken into consideration. Therefore, a description is provided of both the situation in early autumn of 2017 and the development thereafter. The Council produces no economic forecasts of its own; rather, the analysis is based on forecasts published by other analysts and forecasters.

1.1 The international economic situation¹

1.1.1 Broad-based upturn in the global economy

During the autumn of 2017, the global economy grew at the fastest pace since 2011, and in spring 2017 both the OECD and the IMF revised global growth for 2017–2018 in relation to the forecasts. A similar revision was performed once more in spring 2018. The growth rate in the global economy is expected to be close to 4 per cent in 2018. Developed countries are expected to grow by an average of 2.5 per cent and the growth rate for the emerging economies is predicted to almost double.² Stronger investment growth and increased trade and industrial production fuelled developments. At the same time, faith in the future among companies and consumers has been strengthened, not least in the Eurozone.

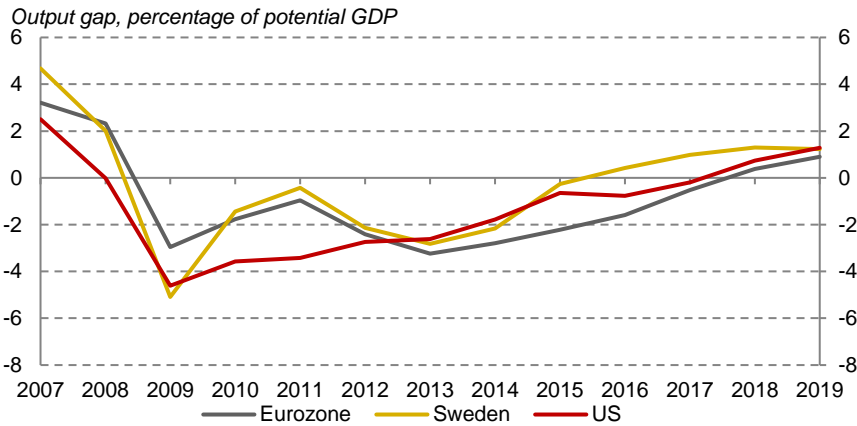
A surprising rate of growth was observed in several countries, including the US, Japan, China, Russia and Brazil. In the Eurozone, the economic upturn now encompasses most countries, and there appears to be room for a continued strengthening of the economic situation in the near future (Figure 1.1). The US economy entered a

¹ The section is based on information from the IMF (2017a, 2017b, 2018a, 2018b) and OECD (2017b, 2018).

² IMF (2018b), Table 1.1.

slight upturn in 2017, which has continued to be strengthened during early 2018. In Britain, growth is stymied by the uncertainty surrounding the negotiations on secession from the EU; the growth is expected to be around one percentage point weaker on average for all developed countries.

Figure 1.1 The economic situation in the Eurozone, Sweden and the US



Note: The output gap shows how actual GDP deviates from its long-term level (potential GDP) and is expressed as a percentage. A positive gap indicates that the economy is experiencing an upturn, while a negative gap indicates a recession. The gaps shown are an aggregate of the gaps of the OECD and the IMF.

Source: IMF (2018b), OECD (2017b) and own calculations.

Investment growth has begun to increase after a prolonged period of very low global investment. The manufacturing industry's confidence indicators in the US and the Eurozone indicate continued strong demand development in 2018. Unemployment has fallen rapidly in several major OECD countries, and consumer confidence is strong in many respects. Together with high capacity utilisation in many countries, these factors advocate rapid investment growth over the next few years. This benefits, inter alia, Swedish export industry, which largely produces investment products.

Global trade has also begun to accelerate once more. Trade growth fell dramatically in conjunction with the financial crisis and the recovery has since been slow. Last year, global trade volumes grew by more than 5 per cent, a rate approximately twice as high as in 2012–2016.

The underlying inflation in the Eurozone has been low for some years. The ECB has therefore continued to pursue an expansive monetary policy, but has reduced the scope of the so-called quantitative easing. In the US, where inflation has been more in line with the Federal Reserve's target, monetary policy has continued to slowly normalise.³ As the economic situation is improving in much of the world, it is to be expected that base rates will rise gradually. Thus far, however, monetary policy continues to support the broad-based economic upturn.

Global growth is also supported by the fact that fiscal policy in several major countries is less restrictive than before. A comprehensive tax reform in the United States, which gives US fiscal policy a very expansive profile, is a clear example of this. The extensive fiscal measures that the new coalition government in Germany has decided to implement are another.

1.1.2 International risks

It should be noted that the economic upturn currently taking place is mainly cyclical in nature and the global growth rate will slow after 2019 according to the IMF forecast. There is a great need for structural reforms in many respects in order to improve growth prospects in the long term. Two areas of concern are the rising proportion of elderly residents in many countries and low global productivity growth (see section 1.2.5). These factors, along with a smaller capital stock, seem to suppress the potential growth of the largest developed economies. The conditions for growth during the next economic downturn may therefore be considered worse than before.

High asset prices pose a significant risk in many parts of the world. Rising interest rates are likely to lead to a rapid decline in prices, both on housing and the financial markets. Concern by stock markets in this regard is illustrated by the rapid drop in prices triggered by a statement by the newly-appointed Federal Reserve chief concerning the strength of the US labour market. A prolonged

³ The Federal Reserve raised the base rate range from 1.00–1.25 to 1.25–1.50 per cent in December 2017. In March 2018 the range was further increased to 1.50–1.75 per cent. At the meeting in September 2017, the Federal Open Market Committee decided to gradually liquidate the Central Bank's securities holdings starting in October of the same year.

period of low inflation and an expansive monetary policy may lead to a continued build-up of financial imbalances. This may contribute to triggering or greatly deepening a future global recession. In addition, many highly indebted households and companies are vulnerable to higher interest rates.

In early March 2018, the US President decided to impose import duties on steel and aluminium.⁴ A wide range of countries, including EU countries, have been granted temporary exemptions from the customs duties and the direct economic effects appear to be limited. However, these measures are contrary to the spirit of the international trading system and risk undermining the work and position of the World Trade Organization (WTO). In the worst case, the measures may also lead to a trade war. International analysts have already warned that protectionist political forces have had an inhibiting impact on trade growth and global economic prosperity.⁵ The measures and possible countermeasures from, for example, China are likely to worsen this situation. They therefore pose a risk to the otherwise healthy economic development that can currently be observed in major parts of the world.

1.2 Developments in Sweden

1.2.1 Economic outlook

Sweden has experienced an economic upturn since the end of 2015.⁶ Early in the autumn of 2017 it appeared as if the upturn would reach its peak in 2018. However, the thriving economy has continued to improve and a recent assessment by NIER indicates that it will peak as far ahead as 2019 (Figure 1.2).⁷ GDP growth is expected to be close to 3 per cent in 2018 and about 2 per cent in 2019.

The economic upturn is reflected in several available indicators and variables: The output gap is clearly positive, resource utilisation is

⁴ The proposal was announced by the President on 8 March and entered into force on 23 March 2018. Refer to www.whitehouse.gov/presidential-actions/presidential-proclamation-adjusting-imports-steel-united-states. The exact design of the measures is still being negotiated at the time of this report going to print.

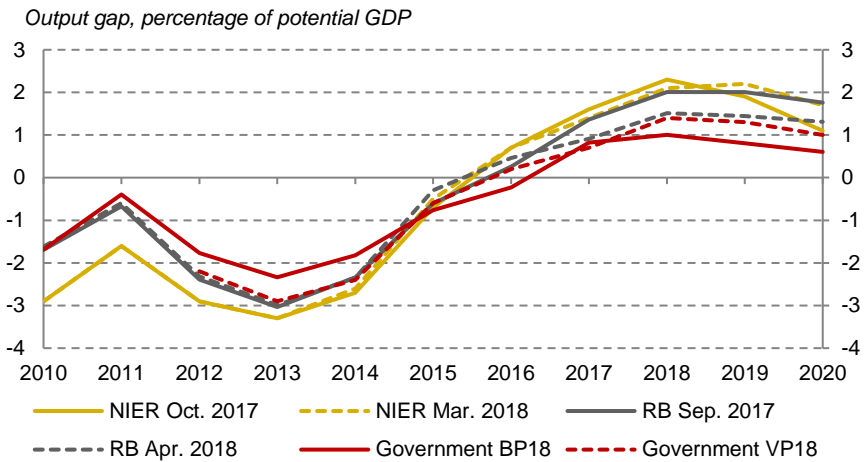
⁵ See e.g. Haugh et al. (2016).

⁶ In this case, economic upturn relates to the output gap being positive.

⁷ For a discussion of other forecasts in the chart, see section 1.2.2.

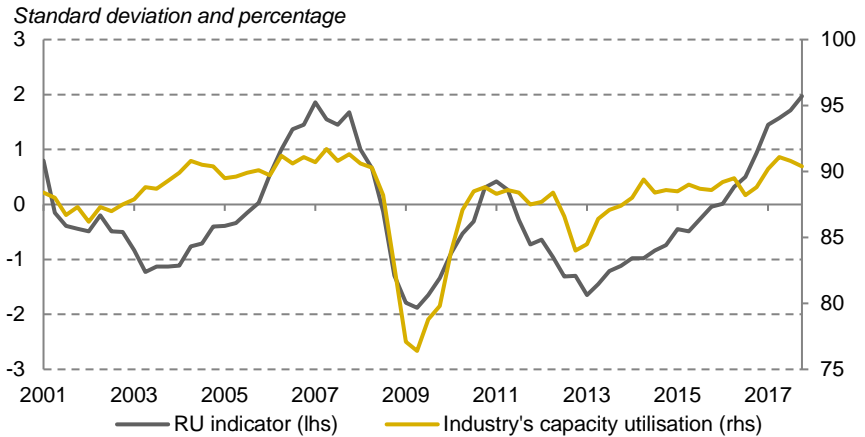
very high and confidence among households and companies has been bolstered (Figure 1.2–1.4).

Figure 1.2 The Swedish economy is strong



Note: The output gap describes how GDP relates to its long-term trend. It thus acts as an indicator of the economic situation. A positive gap means that the economy is in an upturn, while a negative gap means that the economy is in a downturn.
Source: Sveriges Riksbank (2017c, 2018), NIER (2017b, 2018a), BP18 and VP18.

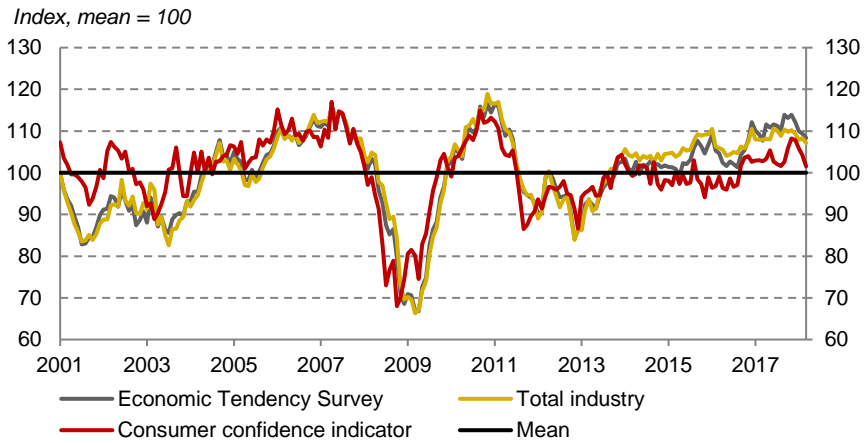
Figure 1.3 Resource utilisation is high



Note: The Riksbank's PCA indicator is a compilation of information in survey data and labour market data. The indicator is standardised around a mean of 0 and a standard deviation of 1. The industry's capacity utilisation is based on a sample survey conducted by Statistics Sweden. The indicator is the ratio between actual production and total production capacity among companies, expressed as a percentage.
Source: Sveriges Riksbank and Statistics Sweden.

Manufacturers say that the volume of orders is very high, with strong demand from both the domestic and export markets. In line with this, companies estimate that demand for goods and services is at the highest level since the spring of 2011 and they expect continued strong demand in the first half of 2018.⁸

Figure 1.4 Strong confidence from households and companies



Source: Economic Tendency Survey, March 2018.

In December, NIER’s barometer indicator began to drop, and between November 2017 and March 2018 the indicator fell by more than 5 units. This drop is not dramatic, and both the household and business confidence indicators are still very strong from a historical perspective (Figure 1.4). It is also too early to say whether it is a break in the positive trend that has held pace since mid-2016, as previous declines of the same extent have proved to be temporary. However, together with the high resource utilisation in the economy, it may be a signal that the peak of the current boom has been reached.

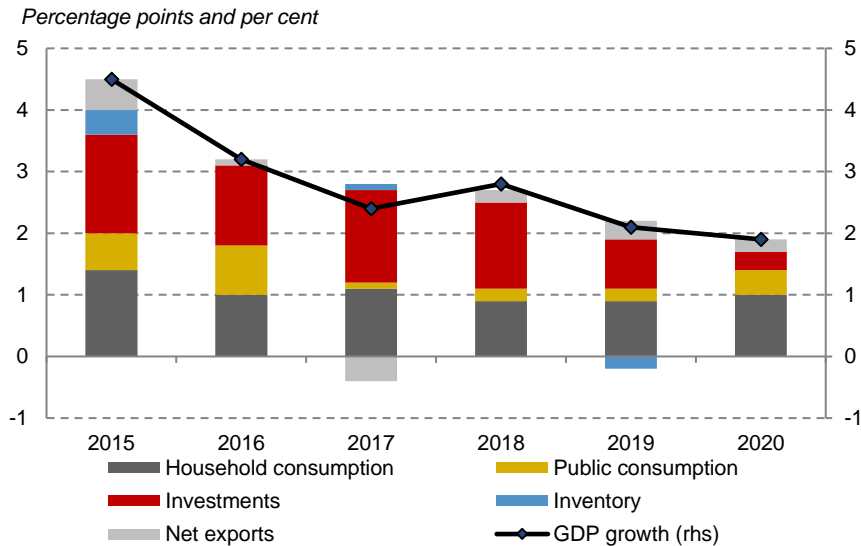
The strong GDP growth in recent years has been largely driven by investments and public consumption (Figure 1.5). It is primarily an increase in housing construction along with increased municipal expenditure for refugee reception that has contributed to the development. At the same time, the net contribution from exports has been relatively small due to the prolonged recession, especially in

⁸ Swedish Public Employment Service (2017) and Economic Barometer, February 2018.

the Eurozone. As the global economy is now showing an upturn, exports are becoming an increasingly important stimulus for growth in the Swedish economy: in import-adjusted terms, exports account for just over half of GDP growth this year and next year.⁹

During the winter of 2017/18, statistics showed that housing prices began to decline. The latest available statistics show that housing prices in the country have fallen by more than 6 per cent since the peak in August 2017. Housing prices in Stockholm fell as much as 10 per cent. The last month’s outcome indicates that the fall in prices has slowed down, with the prices essentially stabilising in the survey published by Valueguard in April. The previously very high expectations of construction companies rapidly diminished during the winter, and a leading indicator for housing construction – the number of building permits granted – fell by 30 per cent in the fourth quarter of 2017 compared to the same period in 2016.¹⁰

Figure 1.5 Changed composition of GDP growth



Note: The columns show changes in per cent of GDP for the previous year, expressed in fixed prices. Forecast 2018–2020.
Source: NIER (2018a).

⁹ NIER (2018a) p. 25, Figure 40.

¹⁰ See e.g. Economic Barometer, February 2018 and NIER (2018a).

Outcome figures for GDP growth throughout the year 2017 showed a weaker growth rate than expected during the autumn. The downward adjustment can mainly be attributed to lower investment growth, inter alia, lower housing investments, and higher import growth. Investments in new housing are expected to decline slightly in 2018 and 2019 according to NIER, but the high capacity utilisation and a need to replace worn real capital entail that investment growth in the business sector up is maintained. Household consumption developed at a somewhat slower rate than expected in 2017. It appears that it will also be slow in 2018, compared to the outlook in the autumn. The effect of housing price decline on household consumption has been limited thus far, but a new fall in prices may lead to a sharp drop in household consumption. Together with a more rapid slowdown in housing investment than expected, this represents a significant risk for the current economic development.

1.2.2 Differences in forecasts

In the autumn of 2017, the view of real GDP growth in the coming years differed very little between the Government, NIER and the Riksbank (Table 1.1). Both the Riksbank and the Government forecast slightly stronger growth over time when BP18 was presented compared to NIER's October forecast, but this can largely be explained by differences in available outcome data.¹¹

Despite the consensus on growth, a varied picture of the strength of the economy emerged during the autumn. In October, NIER estimated that the positive output gap was significantly greater than the Government's in BP18. According to NIER, the Swedish economy was thus experiencing a significantly stronger boom than the Government suggested. In line with this, NIER showed a weaker cyclically adjusted saving for 2018. The difference amounted to 0.6 per cent of GDP, which corresponds to approximately SEK 25 billion.

In its March forecast, NIER indicated a later date for when the upturn in Sweden is expected to peak (Figure 1.2), while at the same time revising and downgrading the strength of the economy in the

¹¹ In October, NIER had access to outcome figures for the second quarter of 2017, which were not available when BP18 and the Riksbank's September forecast were published. The outcome for GDP growth was weaker than in the preliminary figures that came in July.

near future. In VP18, the Government revised and increased the output gap for 2018 and 2019, but still estimated that the gap will be greatest in 2018. In April, the Riksbank toned down its positive view of the economic situation, but is still of the opinion that the Swedish economy is strong. The result of the revisions is that the Riksbank and the Government's output gap do not differ significantly in 2018.

Table 1.1 Macroeconomic key figures

Percentage change, unless otherwise stated	BP18			VP18		
	September 2017			April 2018		
	2017	2018	2019	2017	2018	2019
GDP ¹	3.4	2.6	2.0	2.7	2.9	2.2
Output gap ²	0.8	1.0	0.8	0.7	1.4	1.3
Employment	2.3	1.2	0.6	2.3	1.4	0.6
Unemployment ³	6.6	5.9	5.9	6.7	6.2	6.2
CPIF	1.8	1.7	1.9	2.0	1.7	1.7
Gov. net lending ⁴	1.0	0.9	1.0	1.1	1.0	1.0
Structural net lending ²	0.8	0.6	0.7	0.7	0.5	0.5
Gross debt ⁴	38.6	36.5	34.4	40.3	37.3	34.2
NIER				NIER		
October 2017				March 2018		
	2017	2018	2019	2017	2018	2019
GDP ¹	3.0	2.8	1.8	2.7	2.9	2.1
Output gap ²	1.6	2.3	1.9	1.4	2.1	2.2
Employment	2.3	1.2	0.5	2.3	1.4	0.7
Unemployment ³	6.6	6.3	6.2	6.7	6.3	6.2
CPIF	2.0	1.7	1.9	2.0	1.8	1.8
Gov. net lending ⁴	1.0	0.6	1.3	1.1	0.7	1.1
Structural net lending ²	0.5	0.0	0.5	0.2	0.0	0.1
Gross debt ⁴	39.0	37.4	35.4	40.9	37.0	34.2
Riksbank				Riksbank		
September 2017				April 2018		
	2017	2018	2019	2017	2018	2019
GDP ¹	3.4	2.8	2.1	2.7	2.7	2.0
Output gap ²	1.4	2.0	2.0	0.9	1.5	1.4
Employment	2.1	1.0	0.4	2.3	1.4	0.5
Unemployment ³	6.7	6.5	6.5	6.7	6.3	6.4
CPIF	2.0	1.9	2.1	2.0	1.9	1.9
Gov. net lending ⁴	0.9	0.7	0.8	1.1	0.9	0.9

Note: ¹ Fixed prices, calendar corrected values. ² Percentage of potential GDP. ³ Percentage of the labour force, 15–74 years old. ⁴ Percentage of GDP. The Riksbank does not present structural net lending or gross debt in its forecasts.

Source: Sveriges Riksbank (2017c, 2018), NIER (2017a, 2018a), BP18 and VP18.

In the autumn, the Government held a more optimistic view of how unemployment will develop in the coming years. The unemployment rate forecast in BP18 indicated 5.9 per cent already in 2018, and therefore came in around 0.5 percentage points lower than in NIER and Riksbank's estimates at the same time. In the forecasts in the spring, these differences largely disappeared as a result of the Government revising its forecast upwards while the Riksbank simultaneously revised its forecast downwards. We will return to these forecasts in Chapter 2 and Chapter 5.

1.2.3 The labour market situation

The Swedish labour market is currently strong. The employment rate has continued to increase and is very high when viewed from a historical perspective (Figure 1.6, panel a).

Unemployment has fallen to levels that prevailed before the financial crisis and are now below what is assessed as its equilibrium level.¹² However, since labour force participation has steadily increased, recent employment growth has not resulted in a corresponding decrease in unemployment (Table 1.6, panels a and b). The fact that labour force participation is increasing is, of course, a good thing, as it means that more people are at the disposal of the labour market. This may mean that the long-term employment rate will be higher. Nonetheless, the aggregated measures obscure significant differences between groups and the fact that there are many who still have a weak position in the labour market (see also Chapter 5).

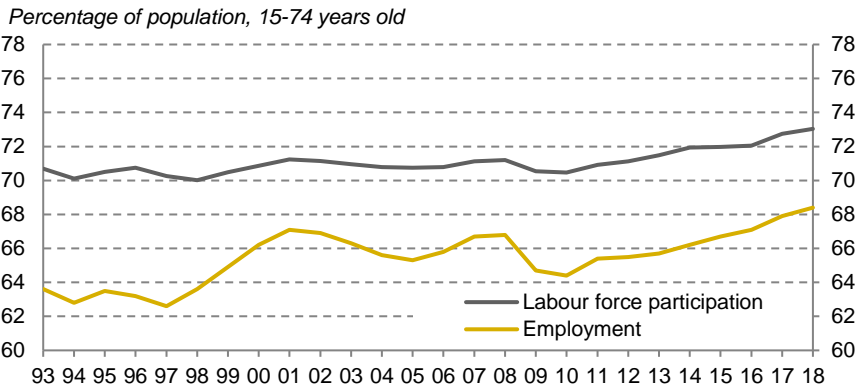
The strong economic upturn and high demand for labour have contributed to the fact that labour shortage is high. The situation is complicated by the fact that an increasing proportion of the unemployed is made up of people who lack the skills in demand. In addition, an increasing proportion of recruitments are being sourced from other workplaces, i.e., relates to people who already have a job¹³.

¹² NIER, the Government and the OECD all make this estimate, even though the size of the unemployment gap, i.e., unemployment's deviation from its equilibrium level, varies in the estimates. The European Commission makes the opposite assessment, i.e., that unemployment is above its equilibrium level (NAWRU). See European Commission (2017), NIER (2018a) and OECD (2017b) and VP18.

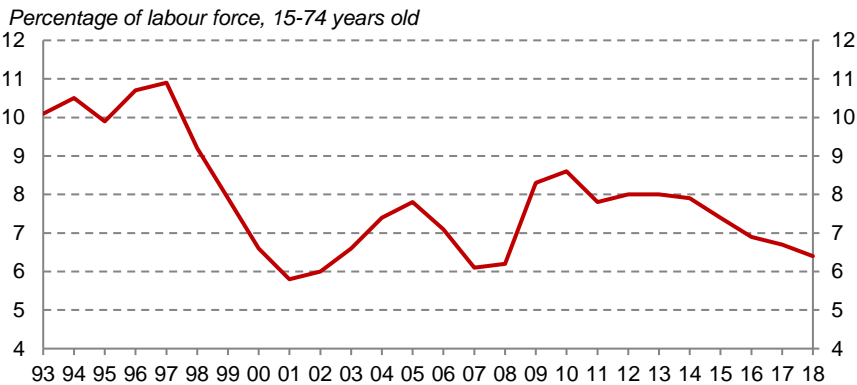
¹³ See Chapter 5 for a more detailed description.

Figure 1.6 A strong labour market

a) Employment levels and labour force participation



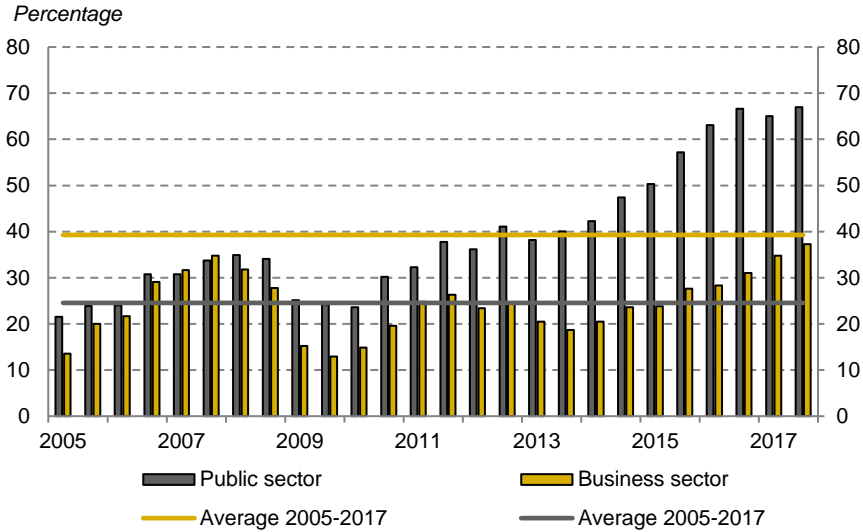
b) Unemployment



Source: Statistics Sweden (AKU).

The shortage figures in both the public sector and the business sector are the highest ever recorded in the Swedish Public Employment Service interview surveys (Figure 1.7).¹⁴ Within public operations, the shortage figures have increased trend-wise since around 2010, and about two-thirds of public employers now state that they have a shortage of labour. The county council has had a significant labour shortage for a long time, and since 2010 the shortage in the municipal sector has increased at a very rapid pace.

¹⁴ Swedish Public Employment Service (2017b), pp. 23–24.

Figure 1.7 Labour shortage

Note: Percentage of employers in the respective sectors that indicate that they have perceived a shortage of labour in connection with recruitment during the last six months in the Swedish Public Employment Service interview survey. Seasonal data.

Source: Swedish Public Employment Service (2017b).

Among private employers, 37 per cent say they are experiencing a labour shortage and the shortage has risen within all parts of the business sector. The increase is particularly evident in the construction industry, the industrial sector and in the private service industries, where the proportion of companies reporting a labour shortage has risen from about 20 per cent in 2013 to 52, 35 and 36 per cent respectively in the latest survey in the autumn of 2017.

The most common consequence for the employer is that the recruitment process takes longer, but as many as one-third of employers state that recruitment has essentially not worked. An important consequence is also that companies are forced to say no to orders. Municipalities and county councils increasingly state that they need to lower the requirements concerning education and professional experience in recruitments. It has also become more common in the public sector to offer higher pay in an effort to solve the recruitment problems.¹⁵

¹⁵ Swedish Public Employment Service (2017b).

The demographic trend will in the near future lead to increased labour demands within schools, healthcare and social care services. Furthermore, the employment plans in the business sector continue to be generally very positive.¹⁶ According to an analysis from NIER, there is so far no indication that labour shortage has hampered employment growth to a large extent. This is due to the large inflow of employable staff to the labour force.¹⁷ However, this is a trend that now seems to be slowing; the labour force is expected to grow at a slower pace in the future. Overall, these factors indicate that the already widespread labour shortage is at risk of becoming more pronounced and negatively impacting employment growth in the future.

1.2.4 Slowly rising prices and wages

Inflation has for a long time been below the inflation target (Figure 1.8). The recurring weak inflation outcomes since 2009 affected the long-term inflation expectations, which began to deviate from 2 per cent around 2012–2013 (Figure 1.9). During 2014, the Riksbank began a phase involving a very expansive monetary policy that is still under way (see Chapter 4). This stimulating policy has contributed to the fact that both actual CPIF inflation and long-term inflation expectations have returned to 2 per cent. However, the Riksbank states that a continued expansive monetary policy is required to ensure that inflation is sustainably reaching the target level. The outcome for CPIF inflation, which was reported at the beginning of 2018, showed that the inflation rate fell slightly, and at the start of the year the Riksbank signalled weaker inflationary pressure during 2018–2019 than previously estimated. The inflation rate is now expected to reach 2 per cent in 2020.

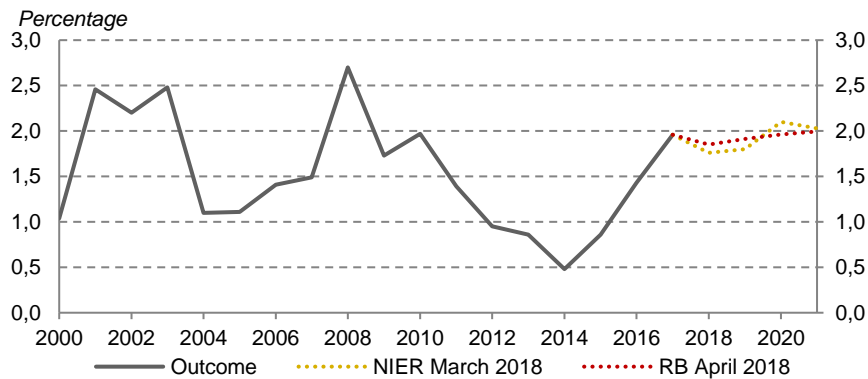
At the same time, wages are not increasing at the pace that can be expected in the current economic and labour market conditions (Figure 1.10). The weaker wage growth in the central agreements likely reflects a weaker productivity increase over the last decade (see section 1.2.5). Another important explanatory factor is the moderate

¹⁶ In February, the employment plans within the building and construction industry were hampered, but the overall employment plans of the business sector are still clearly higher than the historical average. See the Economic Barometer, February 2018.

¹⁷ In-depth analysis “Dämpas sysselsättningen av brist på arbetskraft” [Employment suppressed by labour shortage] in NIER (2017c).

rate of wage growth in the rest of the world, especially in the Eurozone. It has become particularly noticeable in recent years, when the normal correlation between wage growth and the economy has weakened in Sweden and the Eurozone. Within the Eurozone, low resource utilisation has contributed to restrained wage increases since the financial crisis.¹⁸ This means that, in view of its international competitiveness, the wage-setting industry in Sweden has not raised prices and wages as much as the domestic economic situation justifies.

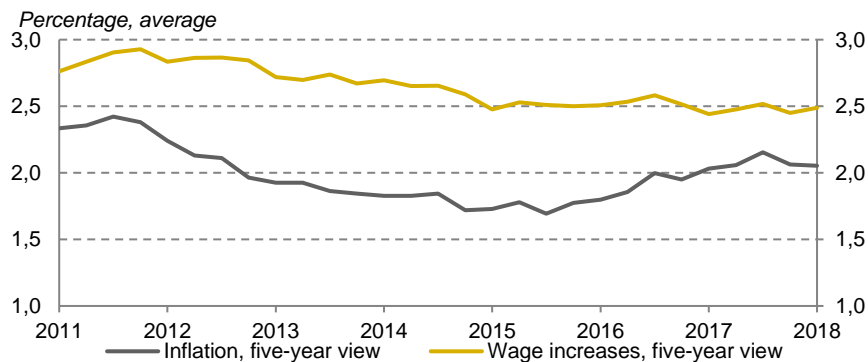
Figure 1.8 CPIF inflation, outcomes and forecasts



Note: Annual mean.

Source: NIER (2018a) and Sveriges Riksbank (2018).

Figure 1.9 Inflation and wage expectations

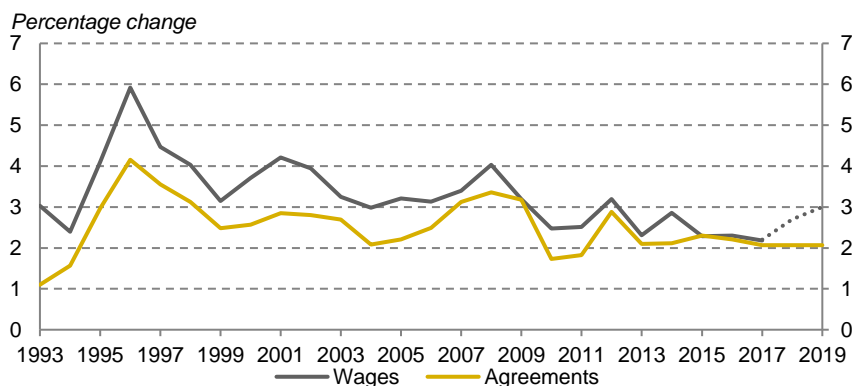


Note: Expectations of inflation and wage growth over a five-year term. Example: The 2018 value reflects the average view of the inflation rate in 2023. All actors.

Source: TNS Prospera and Macrobond.

¹⁸ IMF (2017b).

Figure 1.10 Wages in the business sector, agreements, outcome and forecast



Note: The broken line is NIER's forecast for the actual rate of wage increase.

Source: Swedish National Mediation Office and NIER.

Figure 1.10 also shows that wage drift, i.e., the wage increase beyond an agreement (the difference between the lines in the Figure), has decreased in recent years compared to the ten-year period before the financial crisis. The average wage drift then amounted to 1 percentage point per year, but has only been 0.4 percentage points on average since 2006. It is difficult to know the cause of this. Historically, labour shortages, low contractual wage increases and rising inflation have coincided with increased wage drift. This suggests an increase in the wage growth rate in the future. So far, however, the five-year wage expectations have not risen to the same extent as the inflation expectations.¹⁹

NIER concludes that the low contractual wages indeed have a restraining effect on the actual wage growth, but that the demand situation causes the wage drift to increase over the next few years. The rate of wage growth in the business sector is expected to rise gradually as of this year to subsequently plateau around 4 per cent in 2021. The cost pressure (unit labour costs) is expected to rise gradually and end up around 2 per cent in 2019–2022. The Riksbank, like NIER, estimates that the high resource utilisation in the labour market will lead to a higher wage growth rate in the future. However, according to the Riksbank, the wage growth rate remains weaker than

¹⁹ In-depth analysis "Stark konjunktur med dämpade löneökningar" [Strong economy with suppressed wage increases], Sveriges Riksbank (2017b).

historical trends, mainly due to weak productivity growth and a suppressed wage growth rate in the rest of the world.

1.2.5 Downturn in productivity growth

Productivity in the economy is usually defined as value added in fixed price per hour worked, also called labour productivity.²⁰ Productivity thus measures the value of the goods and services produced with a given amount of hours worked. Productivity varies greatly over individual years due to variations in demand and production. In the event of lower demand, companies generally cut down production but retain their employees (so-called labour hoarding). This means that productivity drops during a recession and increases during a boom. In addition, productivity varies as a result of temporary effects.

The trend development in productivity depends on the size and composition of the capital stock, the composition of the labour force and the technological development. In addition, productivity growth is affected by changes in the industry structure and the transformation pressure in the economy. A clear example of this is the fact that many low-productivity companies were eliminated in Sweden in conjunction with the 1990s crisis, which meant that overall productivity growth was strengthened.²¹

There seems to have been a decline in productivity growth in Sweden since the mid-2000s (Figure 1.11).²² This decline was reinforced in conjunction with the financial crisis and the growth rate in labour productivity has not yet recovered. As Figure 1.11 shows, the development in Sweden is not unique. The OECD countries have exhibited a similar trend since the financial crisis, with a large initial drop followed by a sharp upswing and then moderate growth rates in productivity. In the US, productivity growth was suppressed at an earlier point, around 2004, and after a recovery in the period 2010–2011, the US has also had low productivity growth when viewed from a historical perspective. Both the IMF and the OECD

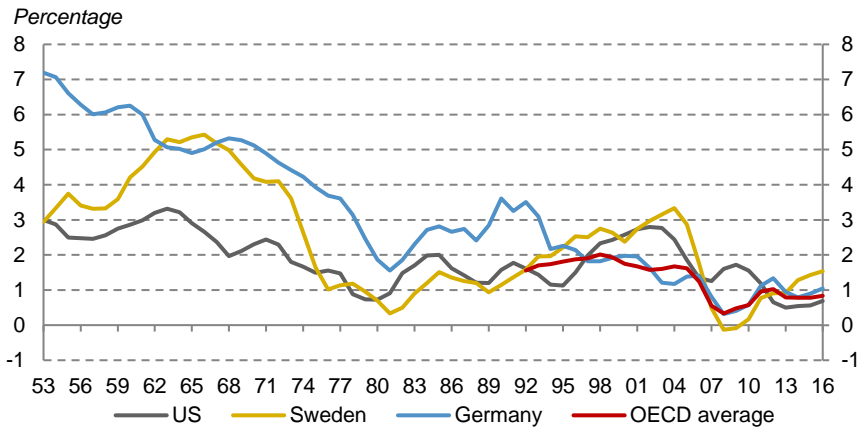
²⁰ The value added is GDP at market price minus product taxes plus product subsidies. It is the added value created in production.

²¹ SOU 2008:14, Appendix 6.

²² For a detailed discussion on the development in Sweden, see, for example, NIER (2017b).

note that productivity growth has slowed in the advanced economies and that this occurred before the financial crisis.²³

Figure 1.11 Labour productivity growth in selected countries (trend)



Note: For the OECD, figures relate to production per employee. For other countries, figures relate to productivity per hour worked. The series are centred four-year moving averages.
Source: Conference Board and Macrobond.

Table 1.2 Average productivity growth during different periods

Percentage change	US	Sweden	Germany	OECD average
1950s	2.7	3.3	6.7	-
1960s	2.7	5.1	5.4	-
1970s	1.7	2.5	4.0	-
1980s	1.4	0.9	2.4	-
1990s	1.7	2.0	2.4	1.7
2000s	2.1	1.7	1.1	1.1
2010s	0.8	1.4	1.3	1.0

Note: Growth in labour productivity. For the OECD, figures relate to production per employee. For other countries, figures relate to productivity per hour worked. The series are centred four-year moving averages.
Source: Conference Board and Macrobond.

Table 1.2 shows the average growth rate every decade since the 1950s. The figures confirm the picture that there has been a gradual downturn in productivity growth in the OECD countries over the past two decades. Most noticeable is the development in the United States, where growth has slowed from around 2 per cent to 0.8 per cent on average per year. In Sweden, the growth rate has been on

²³ IMF (2015) and OECD (2015).

average 1.4 per cent since 2010, compared to 1.7 per cent in the 2000s and 2.0 per cent in the 1990s.

There are several possible explanations for the downturn in productivity growth, and there is currently an international discussion concerning this. The IMF finds that the decline in the bigger developed countries was mainly due to the fact that the growth in total factor productivity (TFP) – the part of production that cannot be explained by the amount of capital and labour – has decreased.²⁴ NIER conducts an in-depth analysis of productivity development in Sweden and reaches the same conclusion.²⁵

The development of TFP is driven, *inter alia*, by technological advances, and has in recent decades been greatly influenced by innovations within the information and communication technology industry (ICT). The ICT industry accounted for an estimated 50 per cent of the TFP development during 1997–2005.²⁶ Several studies show that the effects of ICT innovations on productivity growth follows a cycle: initially they are limited, then strong and finally negligible.²⁷ The positive effects of the many innovations that came around the turn of the millennium are now subsiding. This also seems to be the case in other developed countries. In addition, the dissemination of technology from countries located at the so-called forefront of technology (especially the US) has tapered off as a result of lower productivity growth in these countries.

Another explanation proposed is that the reallocation of resources that occurred after the 1990s crisis, when many low-productivity companies were eliminated, did not take place during the recent financial crisis. This may have meant that financial resources have not been released and thus could not be used by more productive companies.²⁸

The development of TFP in Sweden in the future will largely depend on technological and organisational advances, which are very difficult to predict. This development is affected, aside from by global factors, by elements such as domestic investment in research and development (R&D). Sweden is one of the countries with the

²⁴ IMF (2018b). The countries concerned are Australia, Canada, France, Germany, Japan, Spain, Great Britain and the US.

²⁵ NIER (2017b).

²⁶ SOU 2008:14.

²⁷ See, for example, Lööf (2012), Dabla-Norris et al. (2015) and NIER (2017b).

²⁸ See, for example, NIER (2017b) or Barnett et al. (2014).

highest proportion of R&D investments in the OECD, and is ranked by EU indicators as the most prominent EU innovation country. Business investment in intangible assets has also increased rapidly since 2014, from being restrained during the period 2001–2012.²⁹ Overall, this means that TFP may develop faster in the future. NIER estimates that labour productivity across the whole economy will increase to 1.6 per cent by 2024 and then be in line with the average during the 2000s.³⁰

1.3 Housing prices and household debt

Real housing prices have risen rapidly for many years and several analysts have expressed concern that the Swedish housing market is overvalued.³¹ The Council wrote about this already in the 2013 report.³² Empirical results showed that real housing prices were overvalued by as much as 18 per cent in 2012. However, these estimates did not take into account some of the changes to fundamental factors that have likely contributed to pushing up the equilibrium prices over the analysed period of time. More generous loan terms on the mortgage market reduced liquidity and credit restrictions; the reduction in property tax in 2006 reduced housing costs at a given price level; and increased relocation to the metropolitan areas created further demand in areas where supply was already limited compared to rural areas. All of these factors indicate that the housing prices were probably not as overestimated as the results showed, as was also discussed in one of the Council's background papers in 2013.³³ A weighing up of the situation based on these and other theoretical and econometric considerations ended up, however, in the real housing prices being predicted to fall slightly in the coming years (after 2012). But that has not happened – instead, the real prices have risen by just over 9 per cent on average per year from 2012 to an all-time high in August 2017 (Figure 1.12). The price development for tenant-owned housing in the metropolitan areas has

²⁹ Intangible assets include R&D, databases and programmes. For a more detailed description, see ESA 2010.

³⁰ NIER (2018a).

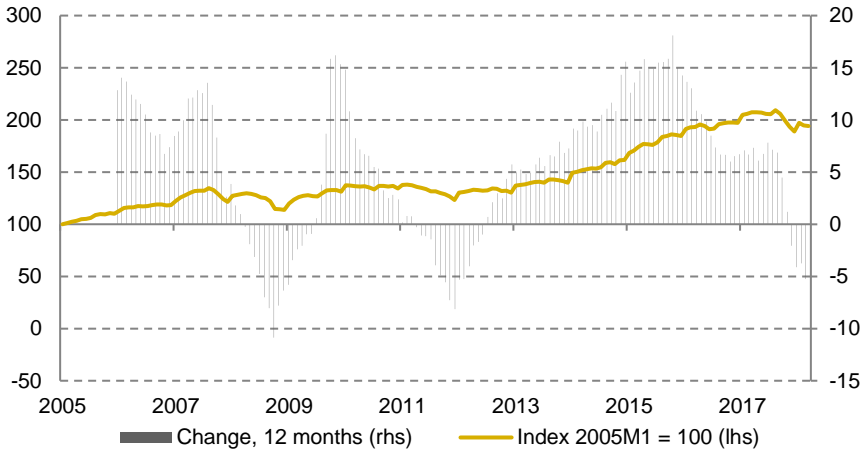
³¹ See, for example, Lind (2017) or Bengt Hansson's statements in SvD on 14 March 2016 and Dagens Industri on 7 October 2017.

³² Fiscal Policy Council (2013) and Sørensen (2013).

³³ Sørensen (2013).

been even more dramatic. Only in autumn 2017 could signs of a decline in prices be seen.

Figure 1.12 Real price development for housing



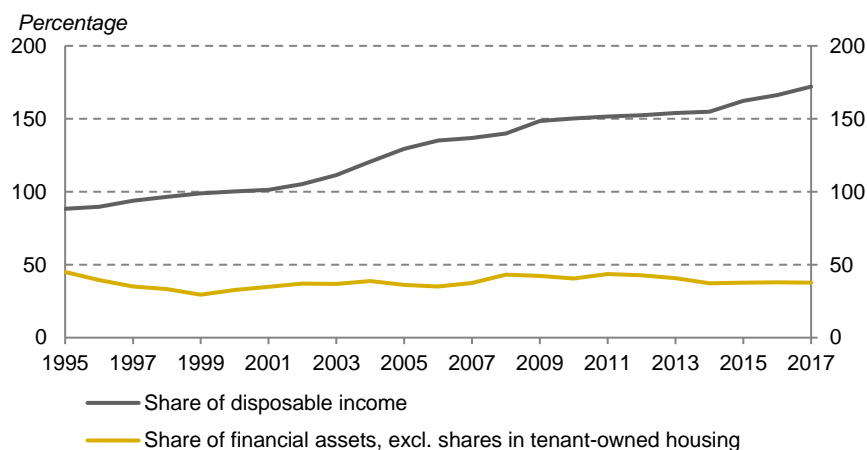
Note: HOX index which covers tenant-owned housing and houses throughout the country.
Source: Valueguard, Statistics Sweden and own calculations.

We propose that the price development after 2012 also reflects for the most part the development in a number of fundamental variables, such as low interest rates, a positive real wage trend, continued insufficient housing development and increased relocation to the metropolitan areas. However, this does not prevent prices from falling if there are changes in these variables or in the market's expectations in respect of these. The recent fall in prices is likely due to increased supply and reduced demand, among other things, as a result of the banks' tougher credit assessment and the imposition of amortisation requirements. This has also led to a decline in construction.

The rapid rise in prices has had consequences that can give rise to macroeconomic imbalances. This applies not least to the risks associated with households' historically high level of indebtedness. Household loan debt grew by 6.8 per cent in 2017, reaching more than 87 per cent of GDP or about 170 per cent of disposable income, mainly due to rising mortgage loans caused by ever increasing housing prices (Figure 1.13). The debt is also unevenly distributed: an increasing proportion of households who have taken

out new mortgages borrow as much as 600 per cent of their disposable income.

Figure 1.13 Household loan debt



Note: The chart only shows the loan debts, as they are the most relevant in the current discussion. If instead, the households' total debts are presented, the debt ratio amounts to 192 per cent of disposable income and 39 per cent of financial assets (excl. shares in tenant-owned housing) in 2017. The bulk of the difference consists of accruals of taxes and social security contributions.

Source: Statistics Sweden and own calculations.

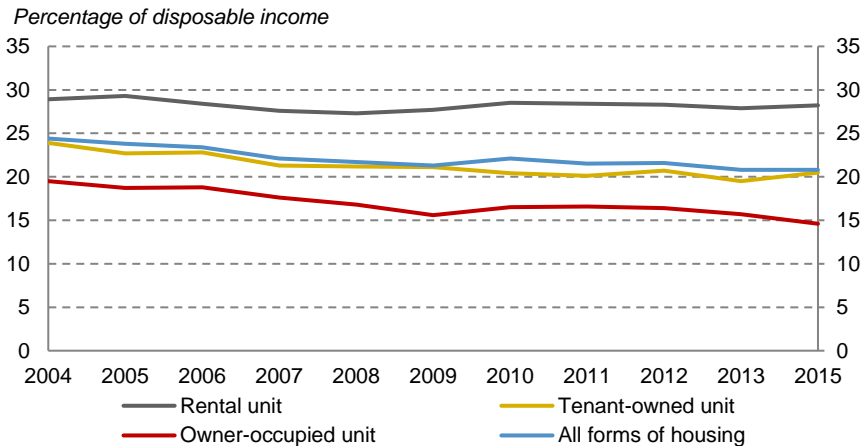
At the same time, it can be noted that the debts in relation to households' total financial assets is essentially at the same level as twenty years ago. In addition, the housing costs for tenant-owned and tenant-occupied properties have fallen as a percentage of income between 2004 and 2015 (Chart 1.14). It is a natural consequence that interest rates have been low and real incomes have developed strongly. Households' financial savings during the period have also been high.

Whether the high level of debt constitutes a problem is therefore not entirely clear. The Swedish Financial Supervisory Authority (FI) and the Riksbank point out that highly indebted households may reduce their consumption in a future crisis, thus deepening the economic downturn.³⁴ However, according to a number of other analysts, there is no foundation for suggesting that highly indebted households would reduce their consumption more than households with lower debts in a recession. NIER and the National Audit Office note that there is insufficient analysis of the macrofinancial risks

³⁴ FI (2017a) and Sveriges Riksbank (2017c).

associated with high debt ratios in order to draw any far-reaching conclusions.³⁵

Figure 1.14 Housing costs



Note: The figures refer to the median value for households in the entire country. The statistics on housing costs previously belonged to the survey Household Finances (HEK), but since 2015 the statistics are located in the Housing Costs survey. The survey is conducted every other year as and from 2015. The following are included in the housing costs. Owner-occupied property: The sum of interest charges, amortisation, operating expenses and costs for maintenance and repair, adjusted for tax. Tenant-owned property: The sum of the fee to the housing association, interest expense and amortisation as well as own maintenance and repair expenses, adjusted for tax effect. Rental property: Sum of the rent and homeowner expenses for maintenance and repair. Tax effect refers to a reduction or increase in tax due to a tax reduction for capital loss and for maintenance and repair relating to the dwelling, as well as the household's property charge for the dwelling. In addition, any interest on transitional reserve is included after the sale of a previous dwelling.

Source: Statistics Sweden.

The Council's view is that the increased indebtedness entails increased vulnerability which may exacerbate problems related to potential imbalances in the housing market. If interest rates rise, there is a risk that households will have to use a significant amount of their savings to cope with rising housing costs. The result of this will be an increasing debt ratio in relation to financial assets. In addition, we will not know how the financial assets are distributed in the population. Most likely, a large proportion of these are found at the high income level (see Chapter 6) while the debts are distributed across all income levels. This means that many households have no buffer to cope with rising interest expenses, but instead have to reduce their consumption. Therefore, it is important to implement

³⁵ Englund and Svensson (2017), NIER (2017c) and RiR (2017a).

measures that gradually reduce household debt. We will discuss such measures in the next section.

The lack of statistics on how the household sector's assets and liabilities are distributed in the population significantly complicates the task of analysing the effects of the increased debt on financial stability. Therefore, the Council, like several other analysts, is calling for more appropriate statistics in this area.

Increased risks are also observable in the commercial real estate market. The price development in the commercial real estate sector is currently strong. The borrowing rates have fallen, but the debt burden in relation to net operating income is at historically high levels. Disturbances in the form of rising interest rates or reduced rental income can therefore lead to problems. FI assesses the risks associated with the sector as significant.³⁶

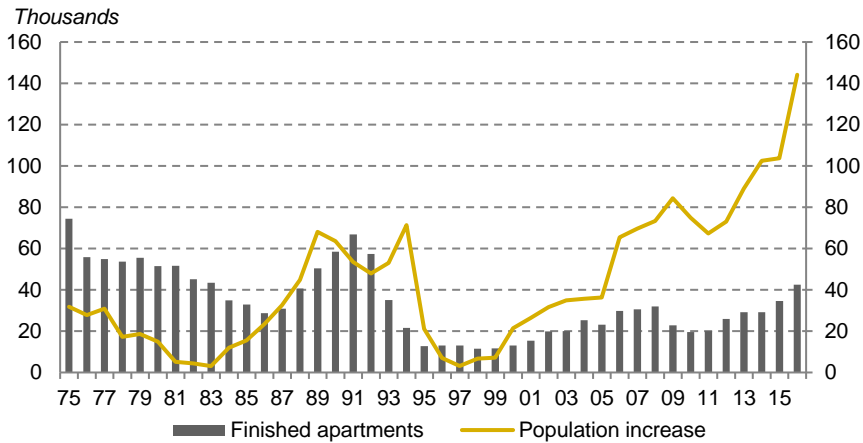
The rise in housing prices has contributed to housing investments reaching very high levels in recent years. This is essentially a positive development, as a significant long-term demand has been met (Figure 1.15). One problem that has recently been noted is that a large proportion of newly-built homes are too expensive and there has been an over-supply in high-priced categories, while at the same time the shortage of tenant-owned properties in lower price segments and of rental apartments persists. One can thus allude to a matching problem in the housing market. These matching problems are difficult to identify, but there are signs that it has become increasingly difficult to find buyers for newly-built tenant-owned properties.³⁷ Housing production has also fallen recently and forecasts have been revised downwards. In this part of the market there may have been speculative factors (i.e. the purchase of new builds for the sole purpose of selling at a higher price when the property is finished). Such activity has more or less ceased with prices no longer increasing steadily, which may have contributed to complicating the sale of newly-built homes. It is also clear that rents are significantly higher in new builds; the median rent for a newly-built apartment in 2017 was SEK 7,807 per month, compared with about SEK 5,000 per month

³⁶ Finansinspektionen (2017).

³⁷ See, for example, "Boverket: det kan byggas för många dyra bostäder" [National Board of Housing, Building and Planning: too many expensive homes are being built], *Affärsvärlden*, 10 November 2017 or "Bostadsministern: Risk att fel bostäder byggs" [Minister for Housing and Digital Development: Risk that the wrong homes are being built], *SvD*, 22 August 2017.

for the existing establishment.³⁸ The risk with this weak matching is that the problems caused by the housing shortage – reduced labour mobility and lower growth – are not being remedied despite intensive construction.

Figure 1.15 Supply and demand of housing in Sweden



Source: Statistics Sweden.

1.3.1 Measures to reduce household indebtedness

In 2016, FI introduced an amortisation requirement which entails that mortgage borrowers with a loan-to-value ratio (i.e. debt in relation to the value of the dwelling) of more than 50 per cent must repay 1 per cent of the loan amount annually. For those with a loan-to-value ratio of 70 per cent, a 2 per cent rate of amortisation applies. FI's assessment is that the amortisation requirement has reduced household vulnerability, but there are still risks associated with households' high and rising debt ratios (debts in relation to income). Therefore, FI has introduced a new amortisation requirement for highly-mortgaged households. New borrowers with a debt ratio exceeding 4.5 times of gross income shall repay 1 per cent of the

³⁸ Source: Statistics Sweden, Rents for dwellings.

debt in addition to previously applicable rules. The proposal came into force on the first of March this year.³⁹

The new amortisation requirement is motivated by a desire to suppress the trend of rapidly rising housing prices and debt ratios, thus reducing the interest and income sensitivity of households and thereby contributing to increased macro-financial stability. However, it is not obvious that the proposed measure is the most appropriate for dealing with the current problems.

A stricter amortisation requirement is likely to contribute to exclusionary effects from the housing market, as households who could otherwise afford the housing costs are not able to cover the additional amortisation.⁴⁰ It is the credit-limited households who suffer the most. Moreover, the requirement can reduce mobility on the housing market as existing borrowers are not affected as long as they retain their home. These consequences hamper the opportunities for many young people to enter the housing market. This, in turn, contributes to reduced mobility in the labour market and thereby has a suppressing impact on economic growth.

Today's tax system, which promotes proprietary housing, provides incentives for indebtedness and also contributes to increased economic inequality. It is therefore the Council's view that changes in tax policy areas would be appropriate to break the trend of increased indebtedness among households. In the 2016 report, we discussed the distribution policy aspects of reducing interest rate deductions and raising the property charge. In the 2017 report, we analysed the impact of the deregulation of the rental market. The Council suggests that these measures – viewed from neutrality, efficiency and distribution perspectives – are better suited to address the housing market development and are preferable to the measures implemented so far.

Regardless of what measures are taken, an adjustment to lower debt ratios will require the prices to fall or come to a standstill in the future. During such an adjustment, households will be more sensitive to various types of disruptions, even if financial stability benefits when a new equilibrium is achieved. It is therefore important to

³⁹ Press release "Regeringen godkänner Finansinspektionens förslag om förstärkt amorteringskrav" [The Government approves the Swedish Financial Supervisory Authority's proposal for an enhanced amortisation requirement], 30 November 2017.

⁴⁰ See, for example, Svensson (2018).

carefully monitor how the measures affect household economy and that any changes in fiscal and housing policies take place gradually.

1.4 Assessments and recommendations

The economic upswing in Sweden since the end of 2015 looks likely to continue in 2018–2019. Growth has largely been driven by increased housing investment and migration-related public expenditure. The contribution to growth from these components is expected to be significantly from this year onwards. The forecasts for housing construction have been revised downward. Due to the current upturn in the global economy, the boom in Sweden is nevertheless likely to be maintained for a while longer. At the same time, inflation does not continuously reach the target and wages do not increase at the rate that can be expected from the economic situation.

The stronger growth in the rest of the world is mainly cyclical in nature and there is a widespread need for structural reforms in order to promote good growth in the long term. This involves, not least, addressing the challenges posed by an increased elderly population in many countries and low global productivity growth.

The trade policy tensions that have built up may have negative consequences for global trade and growth. Thus, the positive global economic development may be more suppressed than in the forecasts.

The differences between the macroeconomic forecasts of the Government, NIER and the Riksbank are relatively minor. An important exception is the assessment of equilibrium unemployment, where the Government makes a more optimistic estimate. This has consequences for the assessment of the strength of the economy and the calculations of structural net lending (see also chapters 2 and 5).

Household debt is a macro-financial risk in Sweden. A major fall in house prices could have noticeable negative effects on household consumption, housing investment and even the financial sector. The Council considers that the measures that should primarily be used to address the development are fiscal changes in the form of gradual restrictions on interest deductions and a gradual increase in property tax.

2 Fiscal policy and the surplus target

2.1 Policy orientation

State finances are strong, writes the Government in BP18, and presents a series of measures that include investments in work, healthcare, schools, climate, the legal system, etc. The reforms amount to SEK 44 billion in 2018 and will increase up until 2020 when they will amount to SEK 82 billion. As financing, the government proposes some income-enhancing measures, such as a tax on air travel and a bonus-malus system for light vehicles. Overall, the measures in BP18 entail that public finances are weakened by SEK 40, 60 and 73 billion respectively for the years 2018-2020. The majority of measures increase spending under the expenditure ceiling, which increases by SEK 36, 51 and 63 billion respectively.¹

Table 2.1 Reforms and funding in BP18

SEK billions	2018	2019	2020
Government reforms:			
More people in work	7.3	10.1	11.4
Sweden must have equitable knowledge-based education	2.5	4.6	7.0
Sweden will be a fossil-free welfare nation	5.0	7.9	10.0
Strengthened welfare system	7.8	13.6	18.9
Sweden's economic strength to benefit everyone	11.9	18.5	22.9
A secure Sweden	6.7	8.3	9.7
Other reforms	2.7	1.9	2.0
<i>Total reforms</i>	<i>43.8</i>	<i>64.8</i>	<i>81.7</i>
<i>Financing, revenue increases</i>	<i>3.4</i>	<i>4.9</i>	<i>8.8</i>
<i>Impact on public finances</i>	<i>-40.3</i>	<i>-59.9</i>	<i>-72.9</i>

Note: The breakdown and names of the measures follow BP18, Table 1.1.

About 60 per cent of the measures involve increased public consumption and include, inter alia, investments in healthcare, more education sites, police and defence. Of public consumption, approximately SEK 14 billion relates to the municipal sector. The transfers to households increase, for example, through increases in child benefits, student grants, sickness and activity compensation, a

¹ Excluding increased expenses that justify a technical adjustment of the expenditure ceiling.

raised ceiling for health insurance and increased housing allowance for pensioners. Different climate initiatives also entail increased transfers to households and companies as well as subsidies for, for example, green cars, electric bicycles and solar cells. Taxes for pensioners are reduced and the Government intends to completely remove the disparity in taxation between pay and retirement by 2020.²

The Government estimates that the measures in the budget bill will together contribute to higher employment and lower unemployment.³ Unemployment is projected to decline by 0.4 per cent in 2018 as a result of the measures in the bill.⁴ The labour market is discussed in more detail in Chapter 5.

2.2 The surplus target

2.2.1 The transition to the new framework

On 1 January 2019, certain changes to the fiscal framework will begin to apply. The surplus target is lowered from 1 to 1/3 per cent of GDP on average over a business cycle, at the same time as the indicators for assessing whether the general government net lending is consistent with the target are being changed. The structural net lending for the current and following year will be used as an indicator to assess the achievement of objectives. To assess whether systematic deviations from the target have occurred in the past, a new indicator – an eight-year retrospective average – shall be used.

If there is a pronounced deviation from the surplus target, the Government will present a plan for how a reversal to the target shall be effected. Such a plan should be time-bound and the reversal shall normally be initiated through the budget bill for the following year. From 2019, a debt anchor is also being introduced, which means that public-sector gross debt, Maastricht debt, should amount to 35 per cent of GDP. If the debt deviates more than 5 percentage points from that level, the Government shall account for the reasons for the deviation through a special letter to the Riksdag.

² In-depth analysis “Budget Bill for 2018” in NIER (2017a).

³ BP18 p. 38.

⁴ BP18 p. 206.

Up until the end of 2018, however, the current regulatory framework still applies. The surplus target is 1 per cent of GDP on average over a business cycle and the Government uses both the structural net lending and the seven-year indicator to assess the achievement of objectives. The Government also presents these indicators in BP18.

The Government's assessment is that the fiscal policy orientation represents an appropriate transition to the new lower surplus target, while at the same time being in line with the current target for fiscal net lending.⁵ Instead, the Council argues that the transition from the current target of 1 per cent of GDP to the new target of 1/3 per cent has become unclear and that the Government has for some time focused policy on the lower surplus target.⁶

2.2.2 Principles for how the Council follows up on the surplus target

The modified framework, which will begin to apply in 2019, also contains, in addition to the lower target level and the new debt anchor, amended criteria for assessing and evaluating the achievement of objectives. The target is still expressed as an average of actual net lending over a business cycle. Previously, a number of indicators were used to assess the achievement of objectives, which we repeatedly criticised. It could, for example, happen that the indicators pointed to different directions and it was unclear how the Government weighed up the information. Thus, it was possible for the Government to favour the indicator(s) that were most beneficial at the time.

In the new framework, structural net lending for the current and following year will be used as an indicator.⁷ We welcome this but wish to emphasise at the same time that structural net lending is a measure that must be interpreted with great caution. To calculate structural net lending requires both a calculation of the actual net lending and an assessment of where the economy is currently located in the business cycle. Assessments of structural net lending can thus differ significantly between different forecasters, even if the actual net lending is the same. It is therefore important for the Government

⁵ BP18 p. 37.

⁶ This was also noted in last year's report, Fiscal Policy Council (2017) p. 116.

⁷ SOU 2016:67, p. 262.

to report its calculations of structural net lending as clearly and openly as possible, including what assumptions are made in the calculations, especially in a situation like the present one where there are significant differences in relation to other forecasters regarding the impact of the business cycle on public finances (see section 2.2.5).

Structural net lending does not need to be at the target level throughout the entire business cycle. The framework allows both actual and structural net lending to vary over a normal business cycle.⁸ If the surplus target is to be achieved over time, it requires that an active economic stabilisation fiscal policy in a recession be matched by active consolidation measures during a boom (see Chapters 3 and 4).⁹

Since 2014, the Budget Act requires that the Government, when assessing a deviation from the surplus target, explain how a reversal to the target should be achieved.¹⁰ The reversal plan should be time-bound and normally be initiated in the next budget bill. Such a plan should normally be designed so that the target level for net lending is reached when the economy is in balance. The level of active policy required to correct a target deviation depends on the extent of the deviation, and how quickly it is rectified depends, in turn, on how the economy develops. In a normal economic situation, a target deviation should as a rule decrease with the automatic budgetary consolidation measures, i.e., in pace with the budget being strengthened in the absence of policy decisions.¹¹ In a good climate, the target deviation should decrease faster, and in a tougher climate it may decrease slower. If the deviation cannot be reversed during the following year, the Government's plan should also contain a clear policy commitment for structural net lending for the years to follow.¹²

The Council has since previously been tasked with assessing whether fiscal policy is consistent with the budgetary targets, i.e., the surplus target and the expenditure ceiling, and, in accordance with the new instruction that applies to the Council from 1 February 2018,

⁸ See, for example, SOU 2016:67 p. 263.

⁹ SOU 2016:67, p. 340.

¹⁰ Budget Act (2011:203) Chapter 2, § 1a, paragraph 2.

¹¹ Usually about 0.5 per cent of potential GDP per year, Swedish National Financial Management Authority (2013). See also section 4.3.

¹² Govt. Bill 2016/17:100 p. 85.

the Council's assessment shall also cover the debt anchor and, if necessary, the balanced budget requirement for the municipalities. The Council shall, according to its new instruction, also assess whether a possible deviation from the surplus target is pronounced. If so, the Council shall also assess the reasons that the Government has stated for the deviation, as well as consider and describe the pace at which a reversal to the target should take place. The Council shall conduct "a well-founded overall assessment of relevant circumstances based on the principles for monitoring the surplus target that the Riksdag and the Government have supported."¹³

The concept of a pronounced deviation is not specified in the framework. However, the Council's assessment is that structural net lending should deviate by more than 0.5 per cent of GDP from the target level in order for the deviation to be considered pronounced.¹⁴ The limit for a pronounced deviation reflects that the assessment of structural net lending is subject to great uncertainty.

A deviation from the surplus target need not be a serious problem for the long-term sustainability of public finances as long as the Government pursues a policy which entails that the deviation is temporary. Thus, the existence of a deviation from target does not mean that fiscal policy is incorrectly designed or that there is a violation of the fiscal framework. The surplus target may, on the other hand, not be regarded as met solely based on actual or structural net lending reaching the target level in an individual year.

Indeed, we estimate that a deviation in structural net lending should be greater than 0.5 per cent of GDP to be considered pronounced, but such a numerical limit must be viewed in its context. For example, if structural net lending deviates by 0.4 per cent of GDP from the target level in a systematic manner, the target will not be reached over time despite the fact that the deviation in each individual year is too small to be considered pronounced. Therefore, even a deviation of less than 0.5 per cent of GDP can, if persistent, be serious and indicate that the target will not be reached.

The Government's obligation under the Budget Act to present a reversal plan if there is a deviation from the surplus target is not directly connected to the Council's assessment. When the requirement for a reversal plan was introduced, the Government

¹³ Skr. 2017/18:207 p. 23.

¹⁴ Fiscal Policy Council (2017) p.113.

wrote that assessments and recommendations from expert authorities regarding how to meet the target would be assigned great importance but that they would not automatically impose any demands on the Government.¹⁵ The Budget Act's requirement for a plan to successfully reverse to the surplus target is thus dependent on the Government's own assessment, although the Council's assessments provide an important basis for the Government.

The target is formulated for one business cycle and must therefore be evaluated over such. Furthermore, the idea with the new scheme is to follow a retrospective eight-year average annually and review the target every eight years, i.e., every other term. Variations in structural net lending in individual years shall not lead to net lending over an extended period being directed to a different level than the target level.

The report from the Surplus Target Committee also indicates that the Council is to analyse, both retrospectively and future-oriented, how fiscal policy relates to the fiscal framework.¹⁶ In our analysis of target achievement, we will calculate an eight-year average of actual fiscal net lending that also includes future years, i.e., including the Government's forecasts. This provides information as to whether or not net lending is approaching or straying from the target with the adopted and announced policy. Thus, we consider that an eight-year average of actual net lending over different periods of time, including forecast year, is relevant in assessing the surplus target, not least to determine if any deviations from the target are temporary or lasting.

2.2.3 Government's assessment of the surplus target

From 2019, when the changes to the framework come into force, the Government's evaluation will be based on structural net lending for current and following years, as well as an eight-year retrospective average for actual net lending. In BP18, the Government uses the same indicators as before, but the new indicators are presented in VP18 instead (Table 2.2).

¹⁵ Govt. Bill 2013/14:173 p. 29.

¹⁶ SOU 2016:67, p. 341.

Table 2.2 Indicators for the surplus target, according to BP18 and VP18

		2016	2017	2018	2019	2020	2021
BP18	Gov. net lending	0.9	1.0	0.9	1.0	1.5	--
	Retrospective ten-year average	0.2	--	--	--	--	--
	Seven-year indicator	0.2	0.6	--	--	--	--
	Structural net lending	1.0	0.8	0.6	0.7	1.1	--
VP18	Gov. net lending	1.2	1.1	1.0	1.0	1.3	1.9
	Retrospective eight-year average	--	-0.2	--	--	--	--
	Structural net lending	0.8	0.7	0.5	0.5	0.8	1.7

Source: BP18 and VP18.

In BP18, the Government estimates that structural net lending will exceed 1/3 per cent of GDP for all years up until and including 2020. It is estimated to come in at 0.6 per cent of GDP for 2018, to then rise to 1.1 per cent of GDP by 2020. At the same time, public-sector gross debt is expected to continue to decline, from 38.6 per cent of GDP in 2017 to 32.0 by 2020. The retrospective ten-year average for the period 2007–2016 amounts to 0.2 per cent of GDP and the seven-year indicator in 2016, i.e., the average for 2013–2019, also amounts to 0.2 per cent of GDP. Structural net lending for 2016 is estimated to be in line with the surplus target, and the Government writes that net lending, excluding new measures beyond those proposed in BP18, is expected to increase from 2019. The Government's overall assessment is that both fiscal and structural net lending from 2016 are in line with the surplus target. In VP18, the Government reports structural net lending that for all years is somewhat weaker than in BP18, and estimates that the surplus target will be attained.

2.2.4 Other analysts - NIER, ESV and RiR

In its October forecast, NIER assessed structural net lending in 2017 as 0.5 per cent of GDP and estimated a decline to 0.0 per cent of GDP in 2018, mainly due to the BP18 measures that weaken financial net lending by about SEK 40 billion in 2018. NIER writes: "The National Institute of Economic Research estimates that fiscal net lending for 2018 is not in line with what is required to reach both the current and the new lower proposed level for the surplus target

that applies as of 2019. A restrictive fiscal policy is therefore needed in 2019 to reach the new surplus target.”¹⁷ NIER has prepared a forecast for 2018 and a scenario for the years 2019–2021. From 2019 onwards, the estimation is based on the public welfare commitment remaining unchanged and the surplus target being reached, which NIER defines so that structural net lending will amount to 0.5 per cent of potential GDP each year. NIER’s calculations thus show that there would be a need for budgetary consolidation measures of approximately SEK 30 billion in 2019 in order to achieve this.

Table 2.3 Fiscal and structural net lending

	2017	2018	2019	2020	2021
Gov. net lending					
BP18	1.0	0.9	1.0	1.5	--
NIER Oct	1.0	0.6	1.3	1.0	--
ESV Nov	0.9	0.6	0.5	0.7	--
VP18	1.1	1.0	1.0	1.3	1.9
NIER March	1.1	0.7	1.1	1.2	0.9
ESV April	1.1	0.4	0.3	0.6	1.3
Structural net lending					
BP18	0.8	0.6	0.7	1.1	--
NIER Oct	0.5	0.0	0.5	0.5	--
ESV Nov	0.2	-0.1	0.1	0.5	--
VP18	0.7	0.5	0.5	0.8	1.7
NIER March	0.2	0.0	0.1	0.5	0.5
ESV April	0.5	0.0	0.1	0.5	1.4

Source: BP18 and VP18, NIER and the Swedish National Financial Management Authority.

In its March forecast, NIER is assuming that the budget bill for 2019 will be fully financed, and for the following years, a scenario will be calculated based on an unchanged public welfare commitment¹⁸ and on the new surplus target being reached. Between 2018 and 2019 there are certain austerity measures in line with the automatic budgetary consolidation measures, but it is not enough for the new surplus target to be reached according to NIER’s assessment. Structural net lending is estimated at 0.0 in 2018 and then marginally rises to 0.1 per cent of GDP in 2019. For 2020 and beyond, NIER calculates a scenario based on a sustained welfare commitment at the 2019 level. The conclusion is that budgetary consolidation measures

¹⁷ NIER (2017a) p. 47.

¹⁸ NIER defines an unchanged welfare commitment as unchanged staff density within public services and transfers that follow wage growth. For a more detailed discussion, see NIER (2018a) p. 59.

of about SEK 20 billion are required in 2019, in addition to over SEK 10 billion in 2020, to maintain the welfare commitment at the 2019 level while at the same time meeting the surplus target by 2020.

ESV is basing its November 2017 forecast, like the Government, on the assumption of unchanged policy, i.e., no new measures after BP18, and is calculating the same indicators that the Government uses.¹⁹ ESV notes that a retrospective ten-year average shows that the current target of 1 per cent of GDP is not reached. In addition, ESV writes that the new target of 1/3 per cent of GDP will also not be reached for the years 2017–2019. This is based on structural net lending deviating from the target level during these years and amounting to 0.2, 0.1 and 0.1 per cent of GDP for 2017–2019.²⁰ In its April forecast, ESV writes that structural net lending for 2019, which is estimated at 0.0 per cent of GDP, is too weak in relation to the new surplus target. Nevertheless, public finances are fundamentally strong and gross debt is expected to be within the range of the new debt anchor. ESV also sees a risk of continued procyclical fiscal policy, i.e., that net lending may need to be restricted in the future, in a situation where the economy deteriorates.²¹

RiR does not make its own calculations but assesses the achievement of objectives in relation to the Government's own figures, and also compares the Government's assessment with forecasts from NIER and ESV. RiR assesses fiscal policy in 2018 to be neutral. The measures in BP18 amount to SEK 40 billion but they are counteracted by previously decided measures of SEK 15 billion, the net amount being SEK 25 billion. However, other factors counteract the expansion to some extent so that the total change in structural net lending is a weakening of 0.2 per cent of GDP.²² RiR notes that the current surplus target is not reached in 2018 because structural net lending does not reach 1 per cent of potential GDP. At the same time, RiR believes there is reason to aim for a lower target than 1 per cent in 2018 in order to adjust the net lending to the new target. RiR does not comment on whether the Government is in a position to meet the new target or not.

¹⁹ The 2019 and 2020 measures in BP18 are included in ESV's calculations in the same way as in those of the Government, see section 2.2.

²⁰ Swedish National Financial Management Authority (2017) p. 57.

²¹ Swedish National Financial Management Authority (2018) p. 54.

²² Swedish National Audit Office (2017b) Chapter 3.

2.2.5 Government and NIER structural net lending – a comparison

As noted above, there are major differences between how the Government and NIER assess structural net lending, and thus there are also different views on whether the surplus target is being achieved. The Government assesses that the target is being reached with a margin, while NIER believes that the policy is too expansive to be in line with both the one per cent target and the new target of 1/3 per cent of GDP that will apply from 2019. To determine to some extent what this difference is due to, we perform a comparison here that relates to 2018, between the Government's calculations in BP18 and NIER's forecast from October 2017, i.e., forecasts made close to each other in time.

The difference between the calculations of the Government and NIER is relatively small in terms of actual fiscal net lending. KI calculates public income at about SEK 7 billion lower than the Government, and expenditure is about SEK 4 billion higher. There is thereby a disparity in fiscal net lending between the two forecasts of approximately SEK 10 billion (Table 2.4). The differences are instead greater when structural net lending is calculated, i.e., in assessing how much of the actual net lending is due to the economic situation and how much is independent of the business cycle.

Table 2.4 Comparison BP18 – NIER October 2017

SEK billions, unless otherwise stated	BP18	NIER Oct
Public income	2,358	2,351
<i>Per cent of GDP</i>	<i>48.9</i>	<i>48.5</i>
Public expenditure	2,315	2,319
<i>Per cent of GDP</i>	<i>48.1</i>	<i>47.8</i>
Gov. net lending	42	32
<i>Per cent of GDP</i>	<i>0.9</i>	<i>0.6</i>
Structural net lending ¹	0.6	0.0
Nominal GDP	4,818	4,848
Potential GDP	4,775	4,741

Note: ¹ Percentage of potential GDP. The figures in the table refer to 2018.

Source: BP18 and NIER (2017a).

To calculate this, we firstly need a forecast for the actual GDP level and secondly an assessment of the potential GDP level. The difference between these two gives the output gap. In addition, a method is needed to calculate how the output gap is impacting on

public finances. There are therefore many possible sources for the disparities between the calculations. It may be different forecasts of GDP or public finances, it may be different estimates of the long-term production capacity of the economy, or it may be different methods or assessments in the cyclical correction itself.

With regard to the cyclical correction method, the differences between the Government and NIER are smaller than they have been previously. The Government moved from VP15 to the same so-called disaggregated method used by NIER. There are indeed disparities in calculations and assumptions within this method, but we do not perceive this as a major reason for why the Government and NIER reach such different conclusions regarding structural net lending.

It is above all the major difference between the estimates of the output gap, about SEK 64 billion, that is the determining factor. NIER calculates an actual GDP that is about SEK 30 billion higher than the Government and at the same time a potential GDP that is just over SEK 30 billion lower than the Government. Overall, the disparity in output gap is considerable. The Government estimates in BP18 that the output gap is SEK 43 billion,²³ equivalent to 1.0 per cent of GDP, while in October NIER estimates the output gap at SEK 107 billion,²⁴ corresponding to 2.3 per cent of GDP. This means that the part of the public surplus that is due to the business cycle is significantly greater according to NIER's calculations compared to those of the Government. Even though actual fiscal net lending only differs SEK 10 billion between the two forecasters, their views as to whether or not the policy is in line with the surplus target are therefore not aligned.

The estimates of potential GDP are largely affected by the development of the labour market.²⁵ The Government makes a lower estimate of equilibrium unemployment compared to NIER, which in turn is linked to differences in assumptions about how effective different labour market policy measures are, how quickly new arrivals are integrated in the labour market, etc.

²³ See Table 2.4. $4\,818 - 4\,775 = 43$.

²⁴ See Table 2.4. $4848 - 4741 = 107$.

²⁵ For example, in terms of equilibrium unemployment and long-term levels for employment and average employment periods.

In last year's report, we produced a forecast evaluation which, *inter alia*, showed that the Government tends to underestimate unemployment over a two to three-year period. One reason for this was that the Government made a lower estimate of equilibrium unemployment, which impacts on the actual forecast (see Chapter 5). Our opinion was that the Government should account more clearly for the estimates made and present sensitivity analyses for how different assumptions about equilibrium unemployment affect potential GDP and, in the long run, structural net lending.²⁶

The Government's estimate of equilibrium unemployment is optimistic compared to NIER. This is not just a technical issue but rather is decisive for assessing whether the Government is living up to the fiscal framework. The disparity between the Government and NIER regarding their view of the labour market development is the main reason for their different views on whether the surplus target is achieved.

To get an idea of the magnitudes, we have made rough calculations of how different estimates of equilibrium unemployment affect structural net lending.²⁷ The calculations indicate that a very large part of the difference in potential GDP between the Government and NIER is explained by the Government's lower equilibrium unemployment.

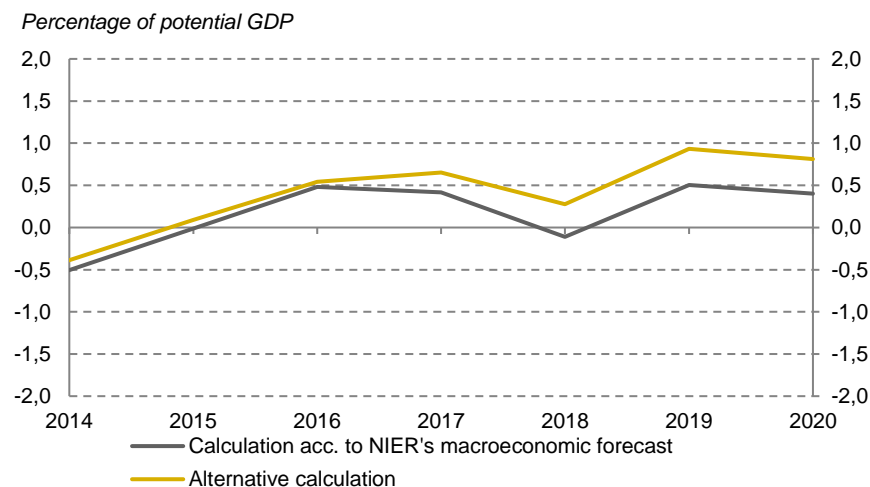
One way to illustrate the differences between the Government and NIER is to calculate how NIER's forecast would change if the Government's equilibrium unemployment was used. One such calculation is shown in Figure 2.1. It is apparent that NIER's calculations of structural net lending would be strengthened by about 0.4 per cent of GDP from 2018 onward if the calculations were based on the Government's equilibrium unemployment. This corresponds to approximately 2/3 of the total difference in structural net lending between the Government and NIER.

The calculations are certainly rough, but they still give an idea of the magnitudes. They show that the estimates of equilibrium unemployment are of great significance in calculating structural net lending and thus in the estimates of the surplus target.

²⁶ Fiscal Policy Council (2017) p. 86.

²⁷ The calculation is based on the differences between BP18 and NIER's October forecast in 2017.

Figure 2.1 Structural net lending using the respective equilibrium unemployment of the Government and NIER



Note: Grey line: NIER's forecast according to 'The Swedish economy' in October 2017. Note that there is a certain deviation from NIER's published forecast for structural net lending due to rounding errors in the included variables. Yellow line: Same model calculation as the grey line but with the Government's equilibrium unemployment from BP18. This affects the calculation of structural net lending, partly via the level of potential GDP and partly via the unemployment gap. Other variables according to NIER's forecast.

Source: NIER, BP18 and own calculations.

In VP18, the Government presents sensitivity analyses showing how public finances are affected if the estimates of equilibrium unemployment change. We welcome this. The Government's calculations, like those of the Council, show that public finances are significantly affected by changes in equilibrium unemployment estimates. The Government's conclusion is that compliance with the surplus target is robust for such changes in the sense that the scenarios are not expected to give any pronounced deviations from the surplus target for 2019.²⁸

2.2.6 Council's assessment of the surplus target

The Riksdag has decided that the surplus target will be reduced to 1/3 per cent of GDP from 2019. However, up until the end of 2018, the old surplus target of 1 per cent of GDP on average over a business cycle will apply, and the Government uses both the retrospective ten-year average, structural net lending and the seven-

²⁸ VP18 p. 145.

year indicator to assess the achievement of objectives. The Government's assessment is that the fiscal and structural net lending are in line with the surplus target from 2016 onwards.²⁹

Our assessment is, as with last year's report, that the one-per cent target from a retrospective perspective has not been achieved, either from a ten-year perspective or from an even longer perspective. Fiscal net lending has averaged 0.4 per cent of GDP since the target was introduced in 2000.³⁰ It is also stated in BP18 that neither the seven-year indicator for the years 2016–2017 nor the retrospective ten-year average reach 1 per cent of GDP. In our opinion, the retrospective follow-up shows that there have been systematic deviations from the surplus target for a long time. The question instead is whether the policy will be in line with the surplus target in the coming years and how a similar long-term deviation from the target can be avoided in the future.

Both current and former governments have stressed the importance of target achievement looking ahead.³¹ Experience shows that this approach in practice means that the Government will downplay the significance of historical deviations from the surplus target. The report from the Surplus Target Committee also highlights the future-oriented perspective. The Committee's definition of target deviation – as supported by the Riksdag – means in principle that historical deviations need not be compensated.³² However, although the target deviation is now being defined based on structural net lending during the current and following year, this should not be interpreted as reflecting less importance on the medium-term perspective in the formulation of fiscal policy. If the surplus target is to be achieved, this requires an active economic stabilisation fiscal policy in a recession be matched by active consolidation measures when resource utilisation is strengthened during a boom.³³

The one per cent target will be valid until the end of 2018 and we have previously stated that this target is not being reached. However, as an adjustment is being made to the new target level of 1/3 per cent of GDP, valid from 2019, it is not requested that the Government present a plan for reversal to the one per cent target.

²⁹ BP18 p. 213.

³⁰ Fiscal Policy Council (2017) p. 116.

³¹ See, for example, Govt. Bill 2013/14:1 pp. 183–184 or Govt. Bill 2017/18:1 p. 212.

³² SOU 2016:67 pp. 262–264.

³³ SOU 2016:67, p. 340.

The uncertainty in the economic assessments and in the estimates of structural net lending is high.³⁴ This is illustrated not least by the major differences between the Government and NIER's estimates of equilibrium unemployment and potential GDP. There are significant differences between different analysts with regard to the degree to which the surpluses in public finances are due to the economic situation or are lasting in nature (see section 2.2.5). The uncertainty can also be illustrated by the forecasts regarding the development of public income. During 2015–2017, revenue from taxes and fees was significantly higher than estimated in the respective budget bill. By 2015, these revenues were about SEK 50 billion higher than estimated in BP15, and for 2016 and 2017 the outcome was approximately SEK 80 and 30 billion higher than estimated in the budget bills respectively. These major discrepancies between budget and outcome illustrate the uncertainty of the forecasts, as well as the fact that fiscal policy, when viewed retrospectively, has been considerably more restrictive than planned in the respective budget.

The Government reports that the measures in BP18 are weakening public finances by 0.5 per cent of GDP.³⁵ In the current economic situation it is difficult to argue that expansive fiscal measures are motivated by stabilisation policy. Rather, net lending should exceed the target so that safety margins and space for stabilisation policy are created in preparation for the next economic downturn (see Chapters 3 and 4 for a discussion on stabilisation policy).

At the same time, there are factors which, seen in the context of the fiscal framework, indicate that the BP18 measures are not too extensive. According to the framework, it is required that a deviation from the target must be pronounced in order for the Government to be obligated to present a plan for reversal. The framework does not contain a definition of what is meant by the term pronounced deviation, but the Council's assessment is that structural net lending should deviate by more than 0.5 per cent of GDP from the target level in order for the deviation to be considered pronounced (see section 2.2.2).

³⁴ See, for example, Stockhammar (2017).

³⁵ BP18 p. 731. The Government's accounts in Table 9.7 also include effects of decisions and notifications made prior to BP18.

Table 2.5 Fiscal net lending, actual and structural, according to BP18

BP18	2016	2017	2018	2019	2020
Gov. net lending	0.9	1.0	0.9	1.0	1.5
Structural net lending	1.0	0.8	0.6	0.7	1.1
Ten-year average	0.2	0.0	-0.2	0.0	0.2
Seven-year indicator	0.2	0.6	--	--	--
Eight-year average	-0.5	-0.2	-0.1	0.0	0.3

Source: BP18 and own calculations.

As stated above (section 2.2.4), it is NIER's assessment that the new surplus target is not achieved. However, NIER's definition of target achievement is not the same as that of the Government or of the Council. NIER suggests that, considering the business cycles are asymmetric, i.e., that the periods of recession are deeper and longer than the boom periods, structural net lending should, in order to be in line with the surplus target, not be 1/3 but instead be 1/2 per cent of GDP.

There is an asymmetry in the business cycles when viewed historically.³⁶ However, this pattern is affected by two deep economic downturns – the 1990s crisis and the 2008–2009 financial crisis – and does not necessarily mean that the asymmetry will continue to exist. Furthermore, the uncertainty in the estimates of structural net lending is significant³⁷ and the difference between 1/3 and 1/2 is contained with a good margin within the framework of normal calculation uncertainty. The surplus target will not only be followed up through structural net lending but also through analyses of how actual net lending will develop over an eight-year period. If such an evaluation shows that there are systematic deviations from the target level, this should be handled in the review to be carried out every eight years. We therefore suggest that analyses of the surplus target based on structural net lending should not focus on any level other than 1/3 per cent of GDP.

KI estimates that structural net lending will be at its lowest in 2018, where it will amount to 0.0 per cent of GDP.³⁸ Based on the Council's assessment that a deviation from the target level should amount to more than 0.5 per cent of GDP to be considered pronounced, NIER's calculations also do not indicate that there is a

³⁶ NIER (2013).

³⁷ Fiscal Policy Council (2017) p. 183 ff.

³⁸ Konjunkturläget [The Swedish economy] (2018a).

pronounced target deviation from the new target level of 1/3 per cent of GDP.³⁹

The Council's assessment is that there is no pronounced deviation in the years 2017–2018 from the current surplus target based on the Government's estimation of structural net lending. However, there is a pronounced deviation when working from NIER's calculation.

We also estimate that there is no pronounced deviation from the new surplus target for 2019, regardless of whether the calculations of the Government or NIER are used as a basis. However, there is reason to be bear in mind the fact that the Government's estimate of structural net lending requires equilibrium unemployment to be lower and potential GDP higher than other forecasters estimate.

2.3 The term unchanged policy

The Riksdag's budget decision concerns one year at a time. Appropriations are announced for the coming year and the Riksdag also approves an income calculation for the coming year. At the same time the budget has a medium-term perspective, which is expressed in several different ways, with the decision to set an expenditure ceiling for the third year ahead probably being the most apparent. However, other decisions in the budget also relate to a period longer than one year, although these decisions are more guiding in nature. The budget decision includes, for example, approval of guidelines for economic and budgetary policy. In addition, the Riksdag approves expenditure limits and income estimates for the second and third budget years to come as guidelines for the Government's continued work.

What is stated in the budget appropriations only applies to the coming year. However, the appropriations are also reported in the budget for the two subsequent years, and these calculations are based on unchanged policy. This may in some cases mean that an appropriation is nominally unchanged and in other cases it is subject to some form of indexation. Appropriations for transfers are also affected by the development of the underlying volumes. What is

³⁹ On the other hand, the deviation is pronounced in relation to the 1 per cent target.

common, however, is that the effects of future decisions are not included in the calculations.⁴⁰

The measures proposed and announced in BP18 are expected to increase the capped expenditure by SEK 41 billion in 2018, SEK 55 billion in 2019 and by SEK 68 billion in 2020, i.e., the scope of measures increases by approximately SEK 14 billion per year for the second and third years ahead. This increase is due to new measures being implemented in 2019 and 2020.

It is a matter of practice to include both proposed and announced measures in the estimates, but the extent of the measures announced in BP18 is greater than normal. The budget will be reinforced automatically for the years following the fiscal year. This is due to the fact that income largely falls in line with GDP development as the tax regulations are assumed to be valid until further notice, while expenditure develops considerably slower based on an assumption of unchanged policy. By estimating comprehensive effects of announced measures already in BP18, a certain amount of space is required in advance, and the space for action in future budget bills therefore becomes more limited. The estimates for the coming years are thus a mixture of consequences of decisions and policy ambitions for the future.

It is not obvious how this change to the term unchanged policy is to be viewed. We have previously requested a more concrete overview regarding policy for coming years in order to show how the reversal to the surplus target will be achieved in the event of a deviation. This can thus contribute to a high level of transparency where, aside from simply presenting decisions for next year, plans for subsequent years are also provided. At the same time, there are problems with incorporating comprehensive effects of future decisions in the budget estimates, especially when the time horizon extends into the next term. In future budgets, it is likely to be unclear which measures are new as some of the measures have been included in the estimates since before. There is a risk that it may be perceived as a breach of promise if the Riksdag in future does not make the decisions required by that the budget. There may also be uncertainties as to whether it may be considered a budgetary

⁴⁰ However, there may be exceptions. For example, in the spring, the Government may present a bill that entails budgetary effects. These budgetary effects are then usually included in the estimates of the previous budget.

consolidation measure to refrain from implementing an announced measure.

The Council, like other analysts, has repeatedly emphasised that a trend in expenditure which presupposes that no new measures will be taken is not realistic. The background to this criticism is that such a calculation method always results in a strengthening of public finances ahead in time, and that such calculations therefore do not provide a true and fair view of whether the surplus target will be achieved in the future. However, the calculation of expenditure in the case of unchanged policy fulfils an important function as it is the starting point for the Government's budget work. This starting point risks becoming less clear when the calculations for coming years contain both effects of decisions already made and such that requires future decisions.

Including announced measures in the budget estimates is not new, nor does it conflict with any rules. Nevertheless, we find it unfortunate that the Government includes relatively comprehensive measures for future years in the budget, despite the fact that the measures are not proposed, without any reasoning regarding what this entails, for example, for future fiscal space and without describing how the estimates are to be interpreted.

2.4 Expenditure ceiling

In BP18, the Government proposes an expenditure ceiling for the State for the third year ahead, 2020, and in VP18, the Government performs an assessment of the expenditure ceiling for the following year.

The expenditure ceilings for the years up to 2018 have been established earlier. For 2018–2020, the Government proposes a technical adjustment upwards of SEK 5 billion.⁴¹

The Government emphasises that determining the level of the expenditure ceiling is a policy decision and that this sort of decision cannot be reduced to a calculation using a pre-defined formula.⁴² The Council agrees that the expenditure ceiling is the expression of a

⁴¹ The technical adjustment is mainly due to an increase in the basic deduction for pensioners reducing municipal income. The municipalities are compensated for this by the State through increased state subsidies which are reported under the expenditure ceiling.

⁴² BP18 p. 216.

political aspiration. It is therefore natural that different governments, that have differing views on how large the public sector should be, also have differing views on what is an appropriate level of public spending.

The expenditure ceilings for 2019 and 2020 entail that the ceilings increase significantly faster than the forecasts for the capped expenditure, resulting in the so-called budget margin growing sharply up until 2020. In BP18, the Government estimates the budget margin for 2019 to be SEK 77 billion and for 2020 to be SEK 120 billion, corresponding to 5.8 and 8.8 per cent of the capped expenditure. The space under the expenditure ceiling viewed over a few years is therefore significant.

Table 2.6 Expenditure ceiling & budget margin in BP18 and VP18

	2017	2018	2019	2020	2021
Budget Bill for 2018					
Expenditure ceiling	1,274	1,337	1,397	1,471	--
<i>Percentage of potential GDP</i>	27.8	28.0	28.1	28.4	--
Capped expenditure	1,236	1,289	1,320	1,351	--
Budget margin	38	48	77	120	--
<i>Percentage of capped expenditure</i>	3.1	3.7	5.8	8.8	--
Spring Fiscal Policy Bill 2018					
Expenditure ceiling	1,274	1,337	1,397	1,471	1,492
<i>Percentage of potential GDP</i>	27.9	28.0	28.1	28.4	27.7
Capped expenditure	1,229	1,282	1,311	1,343	1,364
Budget margin	45	55	86	128	128
<i>Percentage of capped expenditure</i>	3.6	4.3	6.5	9.5	9.4

Source: BP18 and VP18.

The budget margin can be used both for dealing with uncertainty and for future reforms, provided that these are consistent with the surplus target. The expenditure increases contained within the surplus target are in turn linked to the way in which income develops. The higher the future income, the more the expenditure can increase without conflicting with the surplus target. Establishing a high expenditure ceiling thus creates room for increasing both expenditure and income. At the same time, there is reason to ensure that the budget margin for the third year should not be greater than that which allows the expenditure ceiling to have a reasonably controlling

Box 2.1 The expenditure ceiling

The expenditure ceiling for the State was introduced in 1997. Under the Budget Act (Chapter 2, Section 2), the Government is required to propose an expenditure ceiling in the Budget Bill for the third fiscal year ahead. The Riksdag approves the expenditure ceiling.

The expenditure ceiling for the State is a key budgetary policy commitment which is intended to promote budgetary discipline and enhance the credibility of economic policy. A major function of the expenditure ceiling is to provide the conditions for attaining the surplus target. The level of the expenditure ceiling should also promote a desirable long-term evolution of government expenditure. Together with the surplus target, the level of the expenditure ceiling determines the total tax take. The level of the expenditure ceiling should therefore match one's view of how much tax can be collected without excessive socio-economic costs.

The expenditure ceiling also has a key function in the internal budgetary discussions in the Government Offices, because it sets an upper limit on total expenditure in the proposed Government budget. In this way, the expenditure ceiling creates a clear 'top-down mechanism' in the budgetary work, and brings out priorities within and between different areas of expenditure.

The level of the expenditure ceiling is an expression of the Government's view of how its public commitment should develop. The composition of the expenditure and total public-sector assets, and the tax take required to finance the expenditure, are a monetary expression of the ideological positions underlying government policy. There are no formal barriers to the Riksdag reviewing an expenditure ceiling decided on earlier. The practice that has developed is however that the expenditure ceiling is not changed.⁴³ This has only happened in a few isolated cases, and then only as a result of changes in the direction of budgetary policy. It happened, for example, after the change of government in the autumn of 2014, when the expenditure ceilings were raised by SEK 33 billion for 2015, SEK 41 billion for 2016, and SEK 52 billion for 2017.

⁴³ When the Government proposes an expenditure ceiling, so-called technical adjustments are often made to ceilings adopted earlier. This is a system that has existed since the expenditure ceiling was introduced and which is meant to ensure that the expenditure ceilings retain their original tightness even if the reporting changes or there are other technical changes; see Skr. 2017/18:207 pp. 19–20 and Fiscal Policy Council (2016), pp. 46–47.

effect on the trend in expenditure.⁴⁴ The expenditure ceiling does not fulfil a function if it is set so high that it will under no circumstances influence the expenditure.

The ESV and NIER assessments also show that the space under the expenditure ceiling is great. Unlike ESV and the Government, NIER is basing its expense calculations on a so-called unchanged public welfare commitment, which *inter alia* implies an unchanged staff density in the public welfare services.⁴⁵ The calculations thus include the increases in expenditure needed for an unchanged public commitment, even if this requires policy decisions. Although such expenditure increases are included in NIER's calculations, the space below the expenditure ceiling is very great. Instead, the Government and ESV presuppose that no new decisions are made.

To some extent, the large budget margins can be explained by the calculation assumption of unchanged policy, which usually means that certain expenses, such as state subsidies to municipalities, are nominally unchanged.⁴⁶ But even in a more realistic comparison with the trend in expenditure since 1998, the expenditure ceilings will allow rapid growth rates in the coming years.

The Government notes that the spending ceilings up until 2020 allows for an annual increase in spending of approximately 5.5 per cent over the period 2016–2020. This is comparable to the annual rate of increase of the capped expenditure during 1997–2016 of 2.9 per cent.

The fact that the space below the expenditure ceiling is considerably greater than what is contained within the surplus target can be illustrated by the following chart. The starting point is the calculations in BP18, and in addition, we have made the simplified assumption that structural net lending should equal 1/3 per cent of GDP each year in order for the surplus target to be met. It then turns out that between 1/4 and 1/3 of the space under the expenditure ceiling can be claimed without a conflict with the surplus target (Figure 2.2). Therefore, if the Government intends to utilise all or a large part of the space under the expenditure ceiling, it will therefore have implications for tax policy; significant revenue increases would

⁴⁴ This is also pointed out in the framework document, Skr. 2017/18:207 p. 20. A closer review of the guideline for the minimum budget margin is found in VP11, Appendix 4.

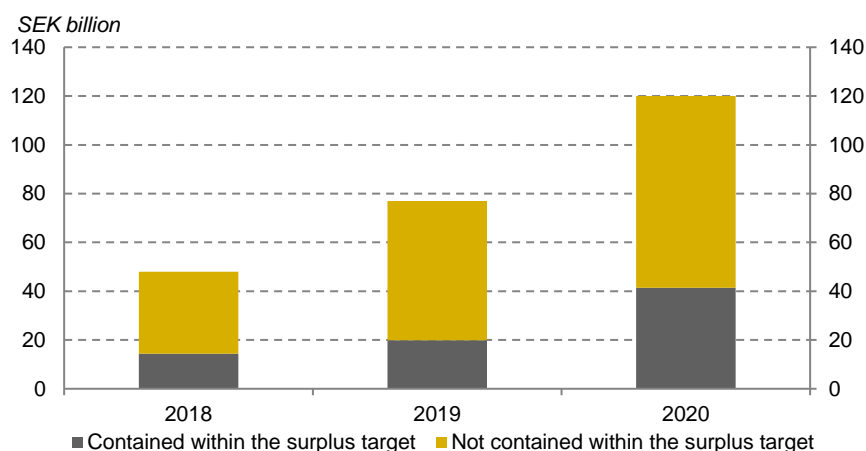
⁴⁵ See NIER (2018b) p. 13, for a definition.

⁴⁶ In BP18, however, unusually large expenditure increases for 2019 and 2020 are included in the calculations. Without these, budget margins would have been even greater (see section 2.3).

be needed to finance expenditure development in line with the ceilings.

The fiscal framework is not designed to steer policy towards a larger or smaller public sector. The framework is neutral in this regard. The surplus target is, in principle, consistent with any level of income and expenditure, as long as income exceeds spending by 1/3 per cent of GDP on average over a business cycle. What is considered an appropriate level regarding public sector scope is a policy issue.⁴⁷

Figure 2.2 Space under the expenditure ceiling 2018–2020



Note: The chart should be seen as an illustration of magnitudes and not as an exact calculation.

Source: BP18 and own calculations.

However, the Council's opinion is that the Government should justify the level of the expenditure ceiling more clearly and discuss what the projected expenditure trend means for the surplus target and for tax policy. The budget indeed covers one year and the Government can therefore not be expected to present concrete measures for more than one year at a time. At the same time, the budget employs a medium-term perspective, which is clearly reflected in the expenditure ceiling being set by the Riksdag for the third year ahead. The Council considers it highly reasonable for the Government to discuss its views on the desirable expenditure and

⁴⁷ The Government writes in BP18 (p. 767) that the Council's view [on the expenditure ceiling] would result in a reduction of the public part of the economy even if the resources are available. This is a misleading description of what the Council has said about the expenditure ceiling.

revenue development over three years as part of the guidelines for economic and budgetary policy.

2.5 The debt anchor and long-term sustainability

2.5.1 Public-sector gross debt

From 2019, the fiscal framework will be supplemented by a debt anchor. The debt anchor is to be a benchmark and not an operational target, meaning that the public sector's consolidated gross debt, the so-called Maastricht debt, shall amount to 35 per cent of GDP in the medium term. The long-term sustainability of public finances and the stabilisation policy space is fundamentally linked to debt and wealth levels, rather than to financial net lending. However, the surplus target and expenditure ceiling are better suited as operational targets in economic policy.

If gross debt should deviate from 35 per cent by more than 5 percentage points, upwards or downwards, the Government shall submit a special letter to the Riksdag and explain the reasons for the deviation. The debt anchor will be included in the review of the framework that will be done every eight years. There will then be an opportunity to review both the design and the level of the debt anchor.⁴⁸

Public-sector gross debt has been roughly halved in relation to GDP since its peak in the mid-1990s. The dominant reason for why the debt ratio has fallen sharply is not that debt has been amortised but rather that GDP growth has been good. Since 2015, however, debt has decreased both in nominal terms and as a share of GDP.⁴⁹

Table 2.7 Consolidated public-sector gross debt

	2014	2015	2016	2017	2018	2019	2020
SEK billions	1,781	1,837	1,820	1,781	1,759	1,722	1,672
Percentage of GDP	45.2	43.9	41.6	38.6	36.5	34.4	32.0

Source: BP18, Appendix 2, p. 15.

⁴⁸ VP17 pp. 80-88.

⁴⁹ BP18, Appendix 2, p. 15.

Public-sector gross debt is expected to decline from 45.2 per cent of GDP in 2014 to 32.0 by 2020. When the debt anchor begins to apply in 2019, the debt is calculated at 34.4 per cent of GDP, i.e., almost exactly at the target level of 35 per cent. Up until 2020, debt is expected to continue to decline, reaching 32.0 per cent of GDP.

2.5.2 The long-term sustainability of public finances

In February 2018, NIER published its annual report on the long-term sustainability of public finances.⁵⁰ The report is based, for the coming five years, on NIER's December forecast, after which it contains scenarios on two time horizons; until 2040 and 2100 respectively.

The main scenario is based on a number of assumptions and forecasts. The demographic trend is based on Statistics Sweden's population forecast from April 2017. The demographic dependency ratio, i.e., the number of young and elderly people in relation to the working population, is estimated according to the population forecast to exhibit a rising trend, from 0.7 in 2005 to 0.85 in 2040 and then to 0.96 in 2100. Average life expectancy is expected to increase by 7 years over the same period, so that the expected remaining life expectancy for a 65-year-old increases from today's 20 years to about 27 years. NIER also makes the assumption that the elderly are getting healthier. Of the 7 years entailed by the increased life expectancy, five are expected to be healthy years, i.e., a 75-year-old in 2100 will require the same amount of public consumption as a 70-year-old does today.

The calculations are also based on the assumption of a sustained welfare commitment. NIER defines this as an unchanged staff density in the public welfare services. The calculation assumptions also include an increase in the standard of welfare services due to increased or better technical equipment. The compensation levels in the transfer system are assumed to follow the revenue curve.

The main conclusion in NIER's report is that the average financial net lending under these conditions and up until 2040 will be slightly higher than the surplus target of 1/3 per cent of GDP, and that

⁵⁰ NIER (2018b).

public-sector gross debt will fall to just under 30 per cent of GDP. The so-called S2 indicator, the measure used within the EU, also indicates that public finances are sustainable in the long term. NIER has also made calculations that stretch as far as 2040 for some alternative scenarios; one where the standard of public welfare services is unchanged and thus not allowed to rise like in the main scenario, one where equilibrium unemployment is higher and one where it is lower than in the main scenario. The scenario involving a higher equilibrium unemployment – assumed to be 0.3 per cent higher in 2040 than in the main scenario – provides the weakest growth in public finances, however, this calculation also indicates that the debt in 2040 does not exceed the debt anchor level of 35 per cent of GDP. The S2 indicator additionally indicates that public finances are sustainable in all scenarios.

2.5.3 On-lending to the Riksbank

About SEK 250 billion of the public-sector gross debt consists of loans raised by the Swedish National Debt Office in 2009 and 2012 on behalf of the Riksbank in order to strengthen the foreign exchange reserve.⁵¹ The Swedish National Debt Office thus borrowed the funds on the international capital markets and lent them on to the Riksbank. Thus, the Swedish National Debt Office's debts and receivables increased by the same amount and the public net position remained unaffected. The Riksbank's net position remained unchanged. However, the increase in borrowing meant that the Maastricht debt (public-sector consolidated gross debt) increased.

Issues concerning the Riksbank's balance sheet and foreign exchange reserve have been investigated on several occasions. The so-called "Flam commission" proposed rules to strengthen the Riksbank's financial independence and rules regarding the Riksbank's right to reinforce its foreign exchange reserve if necessary.⁵² In March 2017, the Government submitted a referral to the Council on Legislation with proposals that largely, but not entirely, were in line with those of the Flam commission. The law amendments were envisaged to come into effect on 1 January 2018, and a consequence

⁵¹ The amount of approximately SEK 250 billion relates to the market valuation of the borrowing in October 2017.

⁵² SOU 2013:9, Riksbank's financial independence and balance sheet.

of the proposals was that existing loans to reinforce the foreign exchange reserve had to be paid back. However, the Government did not submit a bill, instead it issued an extended directive to the Riksbank Committee on Finance on 12 October, which was tasked with proposing under which conditions the Riksbank may reinforce the foreign currency reserve and how existing loans were to be settled. The Committee was to work from the draft referral to the Council on Legislation and the comments submitted concerning this.⁵³ The Riksbank Committee on Finance shall present its report on the assignment by 31 May 2019.

The issue was also raised by the Surplus Target Committee, which, in conjunction with its debt anchor proposal, discussed events that could affect the development of public-sector debt without affecting financial net lending.⁵⁴ Such an event would be a repayment from the Riksbank to the National Debt Office of loans taken to reinforce the foreign exchange reserve.

The Council has had NIER calculate what the discontinuation of the on-lending would mean for the development of the Maastricht debt. These calculations employ the same assumptions as the main scenario in the NIER sustainability report but also calculate how the public-sector debt is affected if the National Debt Office's on-lending to the Riksbank is repaid, either in full in 2020 or gradually by 2022. The most important results of the calculations can be summarised in the following points:

- The basic scenario, in which on-lending is not discontinued, provides a public-sector gross debt which falls from today's level and plateaus at just under 30 per cent of GDP around 2030.
- If the on-lending is discontinued, the gross debt instead levels out just under 25 per cent of GDP.
- If the on-lending is fully repaid in 2020 or gradually as the loans fall due, it is of no significance other than in the short term.

⁵³ Dir 2017:100, Supplementary Directive to the Riksbank Committee on Finance (Fi 2106:15).

⁵⁴ SOU 2016:67 pp. 219-222.

- If the on-lending is discontinued, financial net lending of approximately 0.05 per cent of GDP will be consistent with a debt anchor of 35 percent of GDP.
- If the on-lending is discontinued and financial net lending amounts to the target level, 1/3 per cent of GDP, gross debt is estimated at approximately 27 per cent of GDP from 2025.

We can thus conclude that the calculations in NIER's basic scenario, i.e., without discontinuation of the National Debt Office's on-lending to the Riksbank, show that public-sector gross debt falls to almost 30 per cent of GDP over about ten years. The debt therefore gradually approaches the lower limit of the +/- 5 per cent range for the debt anchor. However, this scenario also means that average financial net lending is slightly higher than the surplus target. If the on-lending is discontinued, the debt anchor is not expected to be reached by some distance.

We also note that the sustainability estimates are very sensitive to changes in assumptions and calculation conditions. Public finances are now estimated to be significantly more sustainable than a year ago, largely due to the fact that the starting point for the estimates is now improved.

A further observation is that the level of public-sector gross debt is not only due to the development of financial net lending but is also strongly influenced by other factors. One such factor is the management of borrowing carried out in 2009–2012 to reinforce the foreign exchange reserve. Such factors must be taken into account in the assessments of the debt anchor, both when used in the ongoing monitoring of the surplus target and in conjunction with the planned regular reviews of the surplus target and debt anchor level.

2.6 Pension agreement

On 14 December 2017, a cross-block agreement was reached on raising the retirement age.⁵⁵ The agreement entails that the minimum age to start receiving public pension during the period up until 2026

⁵⁵ See the Pension Group's [Pensionsgruppen] agreement on long-term increased and secure pensions, Ministry of Health and Social Affairs, 14 December 2017.

will gradually increase from the current 61 to 64 years of age. Today, according to the Employment Protection Act, the individual has the right to work until the age of 67. By 2023 this age will be raised to 69. The same year, the minimum age is also raised for receiving a guaranteed pension and housing allowance to 66.

The agreement entails that a target age is introduced to which all retirement age-related age limits are linked. The purpose of the target age is to automatically adjust the retirement ages so that welfare and a reasonable pension level can be maintained. In practice, the target age is the age limit that applies to the guaranteed pension and to other benefits (e.g. sickness benefit and unemployment insurance) as the surrounding systems are adapted to it. The technical design of the system will be further investigated. The reform shall be neutral from a fiscal standpoint.

In addition, the basic protection of the pension system shall be improved and focus on the most economically vulnerable, thereby reducing the income gap between women and men. The guaranteed pension should therefore be expanded with a needs-tested supplement.⁵⁶

The agreement also states that the premium pension system is to be retained, but that the system shall be reformed so that it “provides better security and higher future pensions”. A number of principles for how a reformed system will work are laid down in the agreement.

The Council views the Pension Group’s agreement as a welcome addition. In previous reports, we have argued that retirement age should gradually be increased in order for public finances to be sustainable in the long term and for pension levels to be acceptable.⁵⁷ The current agreement is in line with what we have previously advocated. However, we note that no estimates or assessments have been presented for how the reform will affect public finances and pension levels. Much work remains before the concrete proposals can be presented. At the same time, the agreement shows that the political consensus on which the pension reform was based during the 1990s remains intact.

⁵⁶ Ds 2018:8.

⁵⁷ See Fiscal Policy Council (2015) and Fiscal Policy Council (2016).

2.7 Assessments and recommendations

The Council concludes that the target of 1 per cent surplus on average over the business cycle has not been reached when viewed retrospectively. The surplus has also not reached 1/3 per cent on average over the past eight years.

As regards the assessment of whether fiscal policy is consistent with the surplus target based on structural net lending, we can see that there is significant disparity between different calculations of structural net lending. NIER's calculation is half a per cent below that of the Government, largely because the Government makes a more positive assessment of the development of equilibrium unemployment. Calculations of structural net lending are very uncertain and deviation from the surplus target greater than half a per cent is required in order for the deviation to be considered pronounced.

Our assessment is that there is no pronounced deviation from the one per cent target for the years 2017–2018, if the Government's calculation is used as a basis. However, there is a pronounced deviation when working from NIER's calculation. The Council further concludes that there is no pronounced deviation from the new surplus target in 2019, regardless of which calculation of structural net lending is used. Overall, the Council finds that fiscal policy is consistent with the surplus target.

The expenditure ceilings for 2018–2020 are high enough to allow for significant increases in expenditure. The scope allowed by the expenditure ceiling is significantly larger than the expenditure allowed within the surplus target according to current forecasts. This means that if the space under the expenditure ceiling is to be utilising, public revenue needs to be higher. The Council considers that the Government should conduct a more detailed discussion regarding its views on the desirable expenditure and income development over a three-year term as part of the guidelines for economic and budgetary policy.

The estimations made by NIER on behalf of the Council regarding the sustainability of the public finances indicate small risks of an unsustainable development. Public-sector gross debt evens out just under 30 per cent of GDP around 2030.

It may be necessary, prior to the upcoming review of the fiscal framework, to discontinue the National Debt Office's borrowing in order to strengthen the Riksbank's foreign exchange reserve. Such a discontinuation should lead to a technical adjustment of the debt anchor's level.

We welcome the agreement of the Pension Group, which is in line with what the Council has suggested in previous reports, namely that the retirement age needs to be gradually increased in order for public finances to be sustainable in the long term and for pensions to be at a higher level.

3 Fiscal and monetary policy from a stabilisation policy perspective

This chapter begins with an account of the division of responsibility for stabilisation policy that has been in place since the early 1990s. We then describe how decision-makers and economists viewed the division of responsibility between fiscal and monetary policy before the financial crisis, and provide an overview of the economic policy debate that has been ongoing since the outbreak of the crisis. In conclusion, we formulate the Council's views on how stabilisation policy should be organised.

3.1 Responsibility for economic stabilisation

The switch to variable exchange rates in November 1992 fundamentally changed the conditions for Swedish stabilisation policy. In January 1993, the Riksbank decided to introduce an inflation target. Since then, the Riksbank has pursued what is called a flexible inflation targeting policy, in the context of which 'flexible' means that the Riksbank not only focuses strictly on controlling inflation but also tries to counteract cyclical variations in resource utilisation; however, the inflation target is an overarching goal.¹

Since the mid-1990s, the Riksbank has had the main responsibility for the active economic stabilisation. This responsibility is a central starting point in the fiscal framework developed in Sweden after the 90's crisis. Both theoretical reasons and historical experience speak for allowing the Riksbank to have the main responsibility for stabilisation policy.²

One could say that fiscal policy is the basis for monetary policy decisions.³ Fiscal policy for the coming year is presented annually in

¹ "The goal of monetary policy is to maintain a fixed monetary value. As an authority under the Riksdag, the Riksbank should furthermore, without disregarding the price stability target, support the objectives of the general economic policy with a view to achieving sustainable growth and high employment." Govt. Bill 1997/98:40 p. 51.

² Stabilisation policy has historically been a source of macroeconomic instability in Sweden. The Lindbeck Commission (SOU 1993: 16) therefore proposed that the responsibility for monetary policy should be delegated to an independent central bank with the task of safeguarding price stability. Also refer to SOU 1993:20.

³ For a theoretical analysis, see Kirsanova et al. (2005).

the Budget Bill. The bill is submitted by 20 September⁴ and the Riksdag will make a decision on the bill in November-December. The regulatory amendments proposed in the bill will begin to apply no later than 1 January of the following year. In mid-April, the Government may submit an amendment budget and propose changes to the decisions made by the Riksdag in December..⁵ These changes may, if administratively possible, come into force as of 1 July of the current fiscal year. The Government also has the opportunity to submit an amendment budget on other occasions throughout the year if there are special reasons for doing so.⁶

The Riksbank has six regular monetary policy meetings per year. These are host to decisions on how monetary policy is to be formulated; normally, the decision is about which base rate will apply. In addition to the regular monetary policy meetings, the Riksbank may at any time decide to amend monetary policy at an extraordinary monetary policy meeting. Therefore, the Riksbank has scheduled decision dates during the autumn after the Budget Bill has been presented and can therefore decide on how monetary policy should be formulated in light of the fiscal policy pursued. The Riksbank can continuously assess how fiscal policy influences demand in the economy and normally adjusts monetary policy accordingly. This decision-making procedure makes it natural for the Riksbank to have the main responsibility for stabilisation policy.

The Government has presented a new official document concerning the fiscal framework.⁷ We have commented on parts of the document in Chapter 2 and further commentary is provided below. But we will start by summing up a central section of the document concerning the framework that has applied until now.

In the 2011 framework document, the Government described the division of responsibility between fiscal and monetary policy, as well as the principles that it said it followed in the cyclical adjustment of fiscal policy.⁸ According to the 2011 framework document, fiscal policy's most important contribution to economic stabilisation is to

⁴ During parliamentary elections and possibly a change in government, the bill may be submitted later, but no later than 15 November. (RO Chapter 9, Section 5).

⁵ The Government may also submit an amendment budget when the budget bill is presented in September.

⁶ RO Chapter 9, Section 6.

⁷ Skr. 2017/18:207.

⁸ Skr 2010/11:79 pp. 32–36.

maintain confidence in the long-term sustainability of public finances. Failure to achieve this makes the Riksbank's work with securing price stability difficult. In addition, fiscal policy contributes to stabilising the business cycle through the automatic stabilisers. With this division of responsibility, the Government can give structural, allocation, and budgetary aspects steering priority in the formulation of active fiscal policy.⁹ However, this does not mean that the Government can ignore the stabilisation policy implications of its policies. Regardless of what the Government's reasons are for implementing fiscal measures, a stabilisation policy analysis is necessary in order to determine *when* it is appropriate to carry out the measures so that the objectives can be achieved without destabilising the business cycle. If the Government, perhaps for distribution policy reasons, want to raise the ceiling for unemployment insurance, this will entail a weakening of general government net lending. Based on a stabilisation policy perspective, such a change should be implemented in a climate with low resource utilisation. The financing of this measure may then be postponed for a year ahead. Implemented in this way, the measure is consistent with the principles set out in the 2011 framework document regarding how the stabilisation policy should be designed.

3.2 Consensus perception before the crisis

Before the financial crisis during 2008–2009, a consensus was reached among economists and decision-makers on how the recipe for a successful monetary and fiscal policy would look:¹⁰ Monetary policy shall focus on maintaining low and stable inflation by controlling the short-term interest rate. This also means that monetary policy has the main responsibility for stabilising the cyclical position of the economy. The assignment shall be delegated to a central bank with independent decision-making responsibility for monetary policy. Fiscal policy must be regulated. Over the business cycle, the public sector budget is to be balanced or yield a surplus. The fiscal policy's stabilisation contribution comes first and foremost from the automatic stabilisers, and active cyclical measures on a case

⁹ For a definition of active fiscal policy and automatic stabilisers, see box 4.3, p. 99, in the Financial Policy Council (2017).

¹⁰ See, for example, Blanchard et al. (2010) or Feldstein (2009).

by case basis should be avoided. Most OECD countries, including Sweden, have organised economic policy in accordance with this perceived consensus. The reason for this is not primarily theoretical, but based on experience from OECD countries in the 1970s and 80s, where the lack of a long-term perspective meant that fiscal policy was systematically too expansive; this led to a public debt structure that was historically unique.¹¹

The pre-crisis view of fiscal policy as a stabilisation policy instrument can be summarised as follows:

- Because, for practical and political reasons, it can take time before monetary policy measures are implemented, monetary policy is a better instrument for combating cyclical fluctuations;
- Even if fiscal measures are introduced at the right time, they may often be ineffective as the overall demand in the economy for various reasons (such as leakage) does not increase significantly;
- However, if you turn to fiscal policy to address a recession, the measures must be limited in time and scope, as the measures lead to increased indebtedness and, in the worst case scenario, may entail a threat to the long-term sustainability of public finances.

The view on fiscal policy was characterised by how economists viewed the economy at large. Before the financial crisis, the market economy was considered by leading economists to be a stable system that was not prone to succumbing to crisis situations that result in a depression of the kind that hit the world around 1930. If, however, a crisis would arise, it was believed that the problem could be tackled with powerful monetary policy. Only if the base rate had reached its lowest level would active fiscal measures be required.¹² The financial sector was also regarded as a significant engine of economic growth. The many innovations within the financial system – including those that followed in the tracks of the liberalisation of the financial markets in the 1980s and 1990s – were seen as beneficial for the

¹¹ This view is a starting point for the analysis in, e.g., SOU 2002:16. For a current discussion, see Alesina and Passalacqua (2016).

¹² See, for example, Feldstein (2002).

financial system and for the general economy. The knowledge on the workings of the economy was considered to be so comprehensive that the risk of an economic depression was considered negligible.¹³

However, the financial crisis forced governments and central banks to rethink old truths. When the Lehman Brothers investment bank went bankrupt in September 2008, the financial markets periodically ceased functioning and the crisis spread rapidly to other parts of the world economy. Decision-makers appeared during 2008–2009 to find themselves in a conceptual world that many economists had abandoned in the 1970s; fiscal stimuli were now considered necessary when it appeared that monetary policy was not sufficient to lift the recession triggered by the financial crisis.¹⁴

3.3 The post-crisis debate: consequences for Swedish policy

A decade after the outbreak of the financial crisis, there is still a debate about the conclusions to be drawn.¹⁵ Even if the debate is not over, at this point some observations relevant to the arena of policy can be made.

Observation 1: The importance of financial markets

Modern market economies are dependent on the financial sector being able to channel money from savers to investment projects throughout the economy. If a crisis is affecting the banking system, it is very difficult for an economy to return to normal activity. Severe financial crises rarely constitute isolated phenomena, but rather act as an enhancing mechanism that is accompanied by other types of problems in the economy.¹⁶

¹³ Winner of the Nobel Prize in Economics Robert Lucas took an extreme position on this issue. In a 2003 lecture for *American Economic Association* he said: “Macroeconomics was born as a distinct field in the 1940s, as a part of the intellectual response to the Great Depression. The term then referred to the body of knowledge and expertise that we hoped would prevent the recurrence of that economic disaster. My thesis in this lecture is that macroeconomics in this original sense has succeeded: Its central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades.”, Lucas (2003).

¹⁴ See, for example, Blinder (2013).

¹⁵ Several seminars and conferences have been held on the topic “What do experiences taken from the financial crisis mean for economic policy?”. The titles of the books published after these exercises are telling with regard to the knowledge situation: see, for example, Blanchard et al. (2016), “Progress and Confusion: The State of Macroeconomic Policy”.

¹⁶ Reinhart and Rogoff (2009).

The financial crisis during 2008–2009 caused major losses to the economy and increased pressure on public finances. Eurostat has estimated that the economic downturn resulting from the financial crisis caused a production decline in the EU of six per cent in 2009. In addition to this immediate drop in production, the crisis had long-term effects insofar as GDP for the foreseeable future is at a lower level than if the crisis had not occurred. The financial crisis also caused extensive financial costs to the State. According to the European Commission, between October 2008 and October 2010, support measures were implemented within the Union amounting to EUR 4,600 billion or 39 per cent of the EU's GDP; of these, more than EUR 2,000 billion was realised in 2008 and 2009. Public finances have also suffered due to reduced tax revenues as a result of the economic downturn.¹⁷

Economists agree that their analyses and models have not taken sufficient account of the complexity of the financial markets and how the channels between the financial markets and the real economy look and function. There is a lot of work to be done before there is a consensus on how the financial markets can be better integrated into the models used by central banks and finance ministries in order to understand the effects of economic policy, and as support in their forecasting work.¹⁸

Experience from the crisis shows that there are strong reasons for developing what is now called *macrofinancial supervision* and *macrofinancial regulation*. The framework document from 2011 addresses these issues briefly.¹⁹ Since then, a number of changes have been made within the area (see box 3.1). However, in the new document, the Government does not say anything about this policy area.²⁰ This is notable since the financial crisis has shown very clearly that financial imbalances can have major consequences for fiscal policy and public finances.

¹⁷ Govt. Bill 2013/14:228 p. 262.

¹⁸ A critical voice in this debate is Stiglitz (2018). A pragmatic perspective on this issue is found in Lindé (2018).

¹⁹ Skr. 2010/11:79 pp. 36–37.

²⁰ Skr. 2017/18:207.

Box 3.1 The EU's Crisis Management Directive

Following the financial crisis during 2008–2009, a number of measures have been taken in the area of macrofinancial stability, for example, a mortgage cap and amortisation requirement have been introduced, as well as requirements for liquidity buffers at banks. In this box we only comment on one of all the changes implemented, as it has significance for budgetary policy.

The EU Crisis Management Directive came into force in Sweden on 1 February 2016. The directive fundamentally changes the terms for state action in a financial crisis and aims to break the link between state finances and financial crises. This entails, among other things, a so-called resolution procedure that can be activated if financial stability is threatened. The directive means that the State's ability to recapitalise banks with public funds is limited compared to what was previously possible. The regulations require that significant costs be borne by the owners and creditors of the banks; it is only if the losses exceed certain limits that state funds may be used. The resolution procedure gives the State a number of powers, including the right to take control of a defaulting bank. Furthermore, the banks' lenders must also, once the share capital is exhausted, bear losses through debt write-downs. The lenders' receivables can also be converted into share capital if it is required for the business to be able to continue. In Sweden, the National Debt Office is appointed as the resolution authority and can use tools such as debt impairment to manage banks and other financial institutions in crisis. However, it remains to be seen whether this process will be respected in an acute crisis situation. We find that it is open to interpretation whether the Crisis Management Directive has managed to break the link between state finances and financial crises. In July 2017, the European Commission authorised the Italian State to purchase shares for EUR 5.4 billion in the bank *Monte dei Paschi di Siena* in order to ensure that the bank has sufficient capital in the event of a financial crisis. The decision shows that the need for public finance buffers remains.

Source: Govt. Bill 2015/16:5 and the European Commission Press Release on 4 July 2017.

Observation 2: Monetary policy and financial stability

The interaction between the financial market, the real economy and economic policy is also the focus of an ongoing debate on how monetary policy affects financial stability. This issue was also discussed before the financial crisis. In a famous speech in 1996, the then US Federal Reserve Chairman Alan Greenspan asked if monetary policy should not take into account the rapidly rising prices of real estate and shares.²¹ The stock markets reacted directly to Greenspan's suggestion that shares were overvalued and share prices across the world fell the day after the speech. But despite the fact that prices continued to rise in the way that Greenspan had described as unhealthy, the US Federal Reserve did not amend interest rate policy in accordance with what was indicated in the speech.²² Some time after the IT bubble burst in 2000, Greenspan returned with a statement on how the US Federal Reserve viewed rapidly rising asset prices. At a seminar in Jackson Hole in the summer of 2002, he argued that central banks cannot determine when an asset bubble is about to arise, and by the same token will not try to burst a suspected bubble. Instead, the central bank will mitigate the effects after a bubble has burst and stimulate the economy so that it recovers quickly.²³ Following the financial crisis during 2008–2009, the strategy appears to be particularly problematic.

The discussion about what factors monetary policy should take into account has been very intensive for the past few years.²⁴ The policy that has been implemented for an extended period, involving extremely low base rates combined with so-called quantitative easing, is criticised *inter alia* for the expansive effect on the financial markets. Several analysts conclude that the central banks, through this policy, put financial stability at risk.²⁵ This issue has also been discussed in Sweden. During the period 2011–2014, the Riksbank explicitly tried to suppress household debt development and rising housing prices by keeping the base rate higher than was justified by inflation and inflation expectations. That strategy proved not to be successful. In the latter part of 2014, the Riksbank abandoned its

²¹ Greenspan (1996).

²² Shiller (2015).

²³ Greenspan (2002).

²⁴ For Sweden's part, this is reflected, *inter alia*, in the instructions to the Riksbank Committee on Finance's investigation.

²⁵ See, for example, Gavin Davies in the Financial Times on 24 September 2017.

attempts to influence housing prices and indebtedness and returned to only trying to maintain price stability.²⁶

Observation 3: Monetary and fiscal policy in the case of a low real interest rate

Nominal market rates as well as real interest rates have been very low for a few years. A low interest rate limits the possibilities for the Riksbank to lower the base rate in a crisis situation. In the event of an emergency, the Riksbank is referred to unconventional methods (bond purchases, etc.) which in themselves can prove to be problematic and give rise to imbalances. In addition, it has been shown that low real interest rates do not always stimulate the real economy to the extent previously assumed. The global real interest rate has fallen continuously since 1980; overall, this represents a fall of about 4.5 percentage points. There is reason to believe that real interest rates will remain low in the foreseeable future.²⁷ As a result, significant responsibility with regard to stabilisation may fall to fiscal policy. There should therefore be fiscal space to be able to increase budget deficit and government debt when a crisis arises.

A low real interest rate can also be seen as an argument for greater public investment. The argument is relevant as long as such investments are economically profitable.

Historically, real interest rates have been higher than real growth. In Sweden, the difference on average amounted to almost 1 percentage point during the period 1982-2017. For the past few years, however, the situation has been reversed: the real interest rate in Sweden has been lower than real growth since 2013. This means – all things being equal – that public debt as a share of GDP decreases over time (see box 3.2).

²⁶ Goodfriend and King (2016).

²⁷ Rachel and Smith (2015).

Box 3.2 How the ratio between the real interest rate and growth affects debt development

In order to show how real interest rates and growth affect Maastricht debt development, we employ a very simplified model: we use the debt equation for the public sector

$$d_t - d_{t-1} = \left(\frac{r_t - g_t}{1 + g_t} \right) \times d_{t-1} - s_t$$

where d_t is Maastricht debt as a percentage of BNP at date t , r_t is the real interest rate at date t , g_t is the growth rate in real GDP at date t , and s_t is primary net lending, i.e., tax revenues minus public spending on consumption and investments, but excluding interest income and expenses as a proportion of GDP at date t . For simplicity, we assume that primary net lending is zero and there is a debt in period $t - 1$. The following then applies:

If $r_t > g_t \Rightarrow (d_t - d_{t-1}) > 0$, i.e., the debt grows.

If $r_t < g_t \Rightarrow (d_t - d_{t-1}) < 0$, i.e., the debt shrinks.

Observation 4: Inflation is low, as are inflation expectations

Inflation in the world has fallen markedly since the 1980s. In the case of Sweden, there was a break in the trend in the early 1990s. Several explanations have been suggested as to why inflation is currently low. The most commonly proposed explanation is that monetary policy is now efficiently controlling inflation. A wider awareness of the need to prevent the emergence of high inflation has led to an increased focus on inflation control. Monetary policy has been supported by institutional reforms that have made central banks independent of the political system. This has resulted in a more credible policy that has therein been able to control inflation better than before. Some other possible explanations for the low inflation that more observers are highlighting include: the increased globalisation of economies; a lower level of union affiliation among workers, resulting in a weaker pressure upward on wages; increasingly widespread e-commerce and the use of the internet to make price comparisons; and increasing automation in society that makes production cheaper.²⁸

²⁸ Borio (2017) and Haldane (2015).

Box 3.3 The debate on secular stagnation²⁹

Secular stagnation is a long-term state with little or no economic growth. After the 2008–2009 financial crisis, growth in several major economies has not recovered to the level and pace that prevailed prior to the crisis. Former US Treasury Secretary Larry Summers suggests that demographic changes and economic inequality have increased the propensity to save, while at the same time weaker productivity growth has reduced the willingness to investment. This has resulted in a savings surplus that suppresses demand and thereby growth. If real interest rates do not drop to a sufficient degree, the savings surplus will not disappear and the economy will end up in a recession – a state Summers calls *secular stagnation*. Summers suggests that secular stagnation is basically a demand problem.

Summers' claim has not gone unchallenged. Economist Robert Gordon has highlighted the significance of the supply side in relation to the weak growth of the past decade or so. According to Gordon, the problem is due to poorer productivity development. The innovations made today do not have the same revolutionary effect on the economy that innovations had before. With lower productivity growth comes weaker economic growth, reduced corporate investment and lower interest rates. The fundamental difference between Gordon and Summers is the perception of whether there is a balance between potential supply and demand in the economy. According to Summers, demand does not reach up to potential supply, while in Gordon's analysis there is a balance between demand and potential supply.

Economist Kenneth Rogoff believes in turn that neither Gordon nor Summers are right. Instead, he argues that the low growth is due to high private and public debt inhibiting investment and thereby growth, and that it is only when the debts have been settled that we can expect growth to accelerate once more.

Since the debate is still unresolved in respect of the fundamental causes of the weak growth, it has also not been possible to agree on what should be done to overcome the problem. However, during the winter, it has been speculated that the problem is about to be solved and that we can now see signs of an imminent *secular expansion*.³⁰

²⁹ Telungs and Baldwin (2014) as well as Lo and Rogoff (2014).

³⁰ Gavin Davies, the Financial Times on 7 January 2018.

Observation 5: The Phillips curve applies after all

Recently there has been a debate about whether the relationship between resource utilisation and inflation has changed. Although resource utilisation in, for example, the US and Sweden has increased significantly, the wage increases have so far been surprisingly moderate. This has prompted some economists to question the validity of the so-called “Phillips curve” in the short term, i.e., that high resource utilisation tends to lead to prices and wages rising faster and low resource utilisation to a slower increase. So far, however, there is no decisive evidence in international studies to suggest that the Phillips curve no longer applies.³¹ A recent analysis of Swedish inflation also shows that the relationship between inflation and unemployment does not appear to have changed fundamentally.³²

3.4 The Council’s view on stabilisation policy

In the 2011 framework document, the Government outlines its views on how stability policy should be organised and designed. In the document sent to the Riksdag by the Government in April 2018, such an account is lacking.³³ Our opinion is that such an account is greatly needed. Stabilisation policy considerations are central to the design of economic policy. The question of who has primary responsibility for stabilisation policy is therefore fundamental. It is possible that the Government has not changed its view of stabilisation policy since 2011. But in that case, this should be indicated. Stabilisation policy principles and considerations form part of the fiscal framework. We will therefore explain how we view stabilisation policy.

The experience from the financial crisis has not given rise to fundamentally changing the division of responsibility between monetary and fiscal policy which has been in place since the mid-1990s.³⁴ The Swedish fiscal framework need not be revised on this

³¹ Gordon (2013) and Blanchard (2017).

³² Karlsson and Österholm (2018).

³³ Skr. 2017/18:207. Stabilisation policy is mentioned in a handful of places in the document, but the Government does not elaborate on how it thinks stabilisation policy should be conducted and who has the main responsibility for stabilising resource utilisation.

³⁴ Wren-Lewis (2010) or Blanchard and Summers (2017).

point. In normal times, monetary policy is to handle economic stabilisation, but in times of crisis, active fiscal policy is also needed. One lesson learned from the latest crisis is that decision-makers should not assume that the economy will heal itself after a serious crisis. There is a clear risk that the economy will end up in a drawn-out recession unless powerful economic policy measures are taken. There is an important reason for why, during normal economic development, there should be public finance space to be able to cope with a future deep recession through active fiscal stimuli. Our opinion is that the crisis has made it clear that monetary policy may require extensive fiscal policy support in situations where base rate reductions are not enough or are no longer possible to stop declining resource utilisation and stagnation or falling prices.³⁵ Below we discuss the conditions required for an active fiscal policy to be functional in terms of stabilisation effects.

Public expenditure can be divided into consumption, investment and transfers, while public income consists mainly of income taxes, corporate taxes, indirect taxes and social security contributions. Fiscal policy therefore has a large range of instruments to work with, which theoretically makes it possible to adapt the measures to be implemented in the economic situation.³⁶ An important basic principle in such considerations is that fiscal policy should not complicate the Riksbank's efforts to maintain the inflation target: fiscal policy shall not be pursued procyclically. Thus, the timing of decisions and implementation of fiscal measures is crucial for whether fiscal policy provides support to monetary policy.

Fiscal measures must be *well timed*. Stimulatory effects will be strongest at the time when the decline is otherwise at its deepest. This sounds obvious, but in practice it is difficult to achieve because fiscal policy is often employed with a time lag. Usually the processes for decision making and implementation of fiscal policy are longer than for monetary policy. After a stabilisation policy problem has been identified, a government must secure a political majority. Once the decision is made, it usually takes time before it can be implemented. With tax amendments, it is necessary for technical reasons to wait until the next tax year before the decision can enter into force. Changes in public spending are also handled by different

³⁵ Corsetti and Müller (2015) or Auerbach (2017).

³⁶ Torvik (2017).

authorities. For example, it requires planning to commence road construction, and it is not certain that the Swedish Transport Administration has work-ready projects lined up when demand needs to be stimulated for economic reasons. Adopted fiscal measures may therefore, for purely practical reasons, be implemented too late and thus risk destabilising resource utilisation. At the same time, fiscal measures often have, when successfully implemented, a faster effect on demand than a change in the base rate. A change in base rate will take full effect after one to two years, while an initiated road construction project or increased child allowance will have an immediate effect on demand.

The measures must also be accurate. A general tax reduction may, for example, be an expensive way for the Government to stimulate the economy. On the one hand, households and companies can choose to increase their savings, and on the other hand, diminished public finances can cause concern in the financial markets and push up long-term interest rates. Stimulation measures should therefore be targeted at groups with high marginal consumption propensity (typically low income earners) or designed to help allocate consumption or investment over time. In a cyclical downturn, it is possible, for example, to advance planned permanent reforms that strengthen household economy.

Finally, it is usual to specify that the measures are to be *temporary*. This is primarily due to a desire to not unnecessarily weaken public finances in the long term. It can therefore be wise to, when decisions are made about fiscal stimuli, establish these as time-limited. So, for example, a tax reduction can be applied for a limited time period. An increase in contributions can be designed as an additional monthly payment instead of as a permanent increase in the benefit level of each payment. Another way to stimulate the economy is to temporarily increase state subsidies to the municipalities. The purpose of this is to avoid cyclically-contingent staff reductions in the municipal sector that, if implemented, increase unemployment and suppress demand.³⁷

When formulating stabilisation policy, it is crucial to take into account what causes the cyclical downturn. If the swing, for example,

³⁷ During the 2009 financial crisis, state subsidies to the municipalities were increased based on this justification; see the Fiscal Policy Council's commentary on the 2010 Budget Bill as well as the Fiscal Policy Council (2010).

is due to heavy supply shocks, a conflict between stabilising inflation and employment may arise, as was the case during the oil price shocks in the 1970s when inflation rose rapidly in tandem with a rise in unemployment. In such a situation, active fiscal policy is justified even if it complicates matters for monetary policy. In the event of major demand shocks, fiscal policy may actively need to complement monetary policy if it is unable to mitigate the drop in demand, i.e., in a situation where the base rate has reached – or seems to be heading towards – its lowest possible level.³⁸ However, there are limitations in this regard. For example, in the event of a fall in demand that primarily impacts the export industry, domestic fiscal measures cannot prevent exports from declining. The Riksbank, on the other hand, can weaken the exchange rate by lowering the interest rate, which may at least partially mitigate demand shortages. In such a situation, fiscal measures may possibly alleviate the consequences of the infectious effects of an export-oriented economic downturn in other parts of the economy. In the event of a shock that primarily impacts domestic demand, it is easier to suppress the drop in demand with fiscal measures. The question is then whether monetary policy is sufficient or if fiscal policy is also needed to stabilise resource utilisation; in a normal scenario, monetary policy should be sufficient.

If the Government chooses to implement measures purely focused on stabilisation, these should be designed in such a way that they do not compromise the reversal of fiscal net lending to a level in line with the surplus target after resource utilisation has improved. When resource utilisation after a recession has been normalised, both fiscal and structural net lending should be close to the target level, and when there is a boom, fiscal net lending should be sufficiently high to achieve the surplus target.

In order for fiscal policy to function effectively in stabilisation policy, the public debt ratio should be at such a level that there is room to significantly increasing indebtedness in crisis situations. If the debt ratio is already at a low level³⁹, it is possible during a crisis to allow debt to increase and fulfil the function of a shock absorber without the ambition that the debt will promptly reverse back to a certain level after the crisis – it is enough to have the debt ratio sink

³⁸ See, for example, Portes and Wren-Lewis (2015), Allsopp and Vines (2005) or Feldstein (2002).

³⁹ This is a question of such low debt levels that the Government can credibly claim that there is space for managing a deep financial crisis, see Obstfeld (2013).

“organically” as the economy rebounds. The Government can supplement this strategy through debt amortisation using extraordinary income, i.e., income not directly motivated by budgetary policy; for example, this may involve revenue from sales of state-owned companies.⁴⁰

3.5 Assessments and recommendations

The document concerning the fiscal framework submitted by the Government to the Riksdag in April 2018 contains no information about the Government’s views on how stabilisation policy should be organised and designed. We also note that there is no account of how the Government views the importance of the financial sector for the long-term sustainability of public finances. The document presented by the Government in 2011 contained information on both of these areas. We suggest that there is no need to revise the division of responsibility between monetary and fiscal policies that formed the basis for the fiscal framework developed in Sweden since the mid-1990s. During normal cyclical fluctuations, monetary policy can handle the task of stabilisation, supported by the automatic stabilisers of fiscal policy. Monetary policy, however, may in exceptional scenarios require active fiscal policy support, for example, in situations where base rate reductions are not enough or are no longer possible to stop declining resource utilisation and stagnation or falling prices.

Regardless of what the Government’s reasons are for implementing active fiscal measures, a stabilisation policy analysis is necessary in order to determine *when* it is appropriate to carry out the measures so that the objectives can be achieved without destabilising the business cycle. Fiscal policy should strive not to complicate the Riksbank’s efforts to maintain low and stable inflation.

⁴⁰ See, for example, Escolano and Gaspar (2016) or Ostry et al. (2015).

4 Fiscal policy in relation to the business cycle

This chapter analyses and assesses the contribution of fiscal policy to stabilising the cyclical position of the economy. We also discuss unconventional views on how stabilisation policy should be designed in Sweden in the prevailing economic climate.

4.1 Fiscal net lending

Table 4.1 shows how fiscal net lending develops over time according to BP18.

Tabell 4.1 General government net lending 2014–2020 according to BP18

	2014	2015	2016	2017	2018	2019	2020
Gov. net lending, percentage of GDP	-1.5	0.3	0.9	1.0	0.9	1.0	1.5
<i>Adjustments</i>							
Output gap ¹	0.9	0.4	0.1	-0.4	-0.5	-0.4	-0.3
Unemployment gap ²	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Composition of tax bases ³	-0.6	-0.2	0.1	0.1	0.2	0.0	-0.1
One-time effects ⁴	0.1	-0.4	-0.1	0.0	0.0	0.0	0.0
Structural net lending	-1.0	0.1	1.0	0.8	0.6	0.7	1.1
Output gap	-1.8	-0.8	-0.2	0.8	1.0	0.8	0.6

Note: Percentage of potential GDP, unless otherwise stated. Outcome for fiscal net lending during 2014–2016, forecast for 2017–2020.

¹ The output gap was, for example, negative in 2014 which had a negative effect on fiscal net lending. In a normal economic situation, net lending would have been 0.9 percentage points higher than was the case in 2014. Structural net lending is then obtained by adding 0.9 percentage points to the fiscal net lending.

² Unemployment was also higher than equilibrium unemployment in 2014, which meant that fiscal net lending was 0.1 percentage points lower than would have been the case if unemployment had been at its equilibrium level. Structural net lending is then obtained by adding 0.1 percentage points to the fiscal net lending.

³ In 2014, the composition of the tax bases was favourable to fiscal net lending, which means that 0.6 percentage points must be deducted from the fiscal net lending in order for structural net lending to be obtained.

⁴ In addition to the cyclical adjustment, the calculation of structural net lending also takes into account individual events that are deemed to have affected fiscal net lending temporarily. One-time effects 2014–2016 are due to accruals of Sweden's fee to the EU. In 2015 also includes a one-time tax payment from an international group as well as the repayment of insurance premiums from AFA Försäkring.

Source: BP18, Volume 1, Appendix 2, Table 25, p. 17.

For 2014, a deficit is reported in fiscal net lending corresponding to 1.5 per cent of GDP. The deficit was converted to a surplus equivalent to about 1 per cent of GDP during 2015–2016. At the same time, the Government’s assessment is that the output gap has closed in 2016 and becomes positive from then, i.e., the economy entered an upswing from the end of 2016 onward, according to the Government.

Table 4.1 further shows that structural net lending was strengthened significantly between 2014 and 2016, by just under 2 per cent of potential GDP. Thereafter, structural net lending is weakened slightly in 2017 and 2018 to then regain strength. As a rule, structural net lending should be at the target level when the economy is in balance, and above the target level during a boom. The gradual weakening of structural net lending during 2017–2018 is an indication that fiscal policy is stimulating demand in the economy during these years. Although, according to the Government’s estimates, this does not concern any major stimuli, we note that this is happening during a boom.

4.2 Effects of the overall policy in relation to previous years

Table 4.2 below presents the overall budgetary impact of previous parliamentary resolutions, as well as the Government’s proposals and notifications in BP18. The budgetary effects in Table 4.2 have been calculated in relation to previous years and show the extent to which *active* fiscal policy entails a weakening or strengthening of public finances in relation to previous years.

Line 3 in Table 4.2 shows the overall budgetary impact of expenditure and income reforms; a minus sign means that public finances are weakened compared to the preceding year (and vice versa). The figures on this row can be found in Figure 4.2 below under the heading “Active fiscal policy”. For the period 2016–2020, the Government estimates that the net effect on public finances of active fiscal policy is a significant weakening; accumulated over the period, the weakening amounts to SEK 84.7 billion. This active weakening of public finances is implemented when the output gap is positive and during what the Government and other analysts describe as a boom.

Table 4.2 Overall budgetary effects of the Government's policy in relation to previous years

<i>SEK billions</i>	2016	2017	2018	2019	2020
Total expenditure changes	45.2	16.3	21.7	17.9	15.3
Total income changes, net	33.8	8.4	-3.2	-3.7	-3.7
<i>Net effect of changes to income and expenditure on general government net lending</i>	-11.3	-7.9	-25.0	-21.5	-19.0
Percentage of GDP	-0.3	-0.2	-0.5	-0.4	-0.4

Note: The table shows the budgetary effects on general government net lending in relation to previous years of reforms decided and announced earlier and proposed in BP18, and the funding of these. The amounts are rounded and so do not always sum to the rounded totals shown.

Source: BP18, Vol. 1, p. 731.

In the 2018 Spring Fiscal Policy Bill, the Government proposes that additional funds be allocated to regulated transfer appropriations resulting from changed volumes or macroeconomic conditions, i.e., without any new reform being proposed. This means increased net appropriation levels of about SEK 5 billion. In addition, the Government proposes new reforms which entail increased appropriation levels of approximately SEK 4.5 billion. The proposed appropriation changes amount in total to around SEK 9.5 billion in 2018.¹ Although the Government's proposal only involves a marginal weakening of public finances, the Council notes that fiscal policy will as a result become even more expansive.

4.3 Role of fiscal policy in stabilisation policy

Like the OECD and other international analysts, the Ministry of Finance uses the annual *change* in structural net lending as an indicator of how well the Government's active fiscal policy measures are working in terms of stabilisation policy.² This is a crude measure of the stabilisation policy orientation of fiscal policy ("fiscal stance"), and includes not only the active fiscal policy in the Government budget but also several other factors, as presented in Figure 4.2 below. It should be noted in this context that the design of the fiscal policy actions also influences the effect on demand, but this is not captured by this measure.

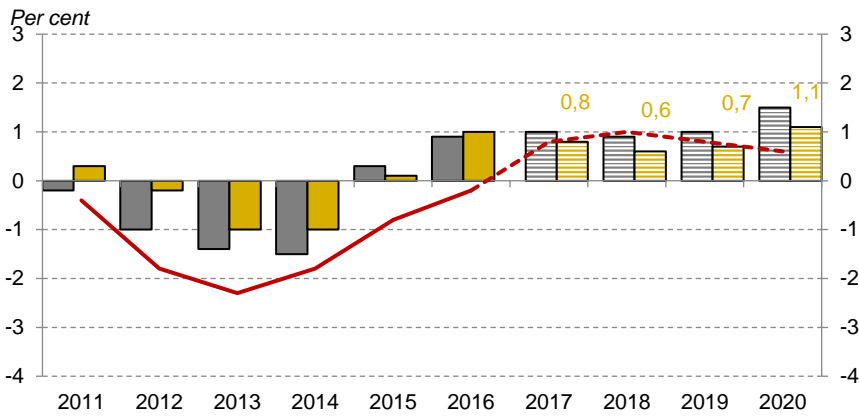
¹ Spring Fiscal Policy Bill 2018, Table 3.1.

² Torvik (2016).

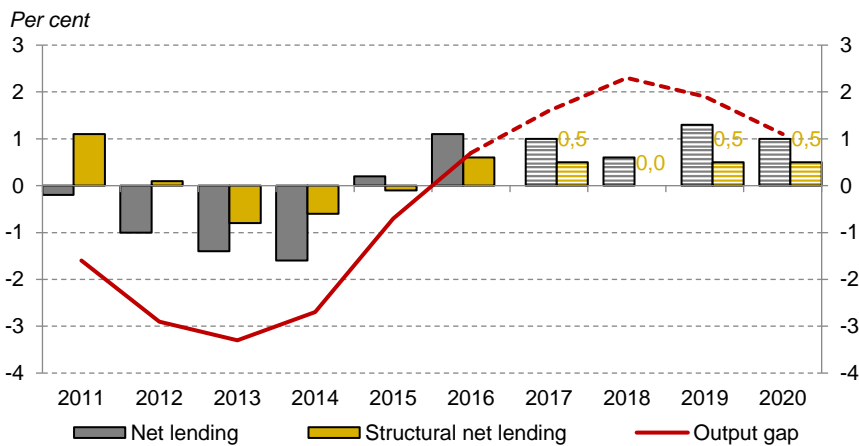
Figure 4.1 (a) shows how fiscal and structural net lending are changing according to the Government's calculations in BP18, and 4.1 (b) shows NIER's assessment from October 2017. The figure also show the Government's and NIER's assessments of how strained resource utilisation is, measured using the so-called output gap.

Figure 4.1 Fiscal and structural net lending along with output gap 2011–2020

a) Budget Bill for 2018



B) NIER October 2017



Source: BP18, Volume 1, Appendix 2, Table 25, p. 17 and NIER (2017a).

It is difficult to determine whether the Government's or NIER's assessment of the level of activity in the economy is the most accurate. However, we note that in recent years the Government has underestimated the power of the economic upturn. NIER has better managed to capture the development. We therefore believe that NIER's assessment is now closer in line with the actual development than the Government's assessment (see Chapters 2 and 5).

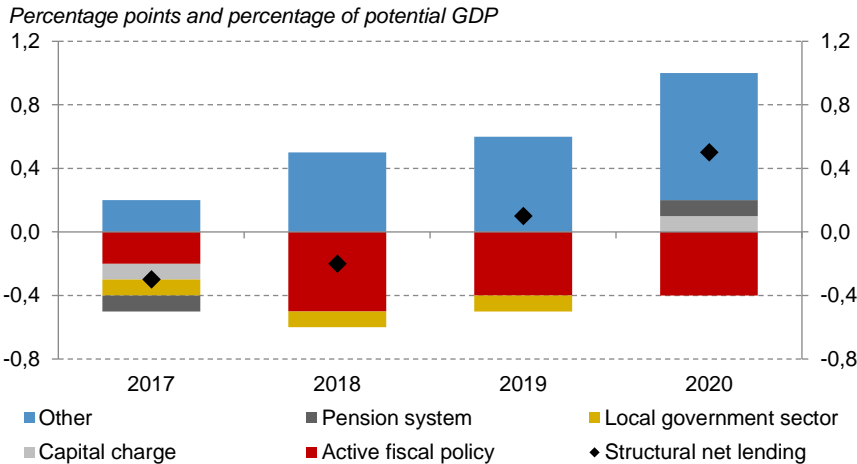
Resource utilisation is high and the GDP gap is positive throughout the period 2017–2020, i.e., the economy is above its long-term sustainable production level. Measured in this way, there is currently a boom taking place. The output gap increases between 2017 and 2018 while structural net lending decreases simultaneously. From a pure stabilisation policy perspective, it would be desirable for public finances in this situation to be strengthened, but instead, structural net lending is weakened by 0.2 per cent of GDP according to Government and 0.5 per cent according to NIER. Fiscal policy thereby strengthens the boom while reducing the space for future active stabilisation measures.

In Figure 4.2 below, the black diamonds indicate how much structural net lending changes over the years. For example, as mentioned and according to the Government, structural net lending is weakened by 0.2 per cent of potential GDP 2018, while it is strengthened by 0.5 per cent of potential GDP by 2020. The bars in the chart show the different components of the change compared with previous years. If the change in structural net lending between the years is close to zero, this indicates that the differences in fiscal policy between these years (apart from the effect of the automatic stabilisers) do not affect demand in the economy. However, if structural net lending is instead weakened, this indicates that the change in fiscal policy in relation to the previous year has an expansive impact on demand during the current year (and vice versa).

We see in Figure 4.2 that structural net lending is weakened between 2016 and 2017 and also between 2017 and 2018. This indicates that fiscal policy becomes *more expansive* during these years. Active fiscal policy significantly weakens structural net lending – by 0.5 per cent of potential GDP – between 2017 and 2018. Changes in the municipal sector also contribute to a slight weakening of structural net lending in 2018. However, the item “Miscellaneous” strengthens net lending by 0.5 per cent of potential GDP. Part of this

gain (0.2 percentage points) consists of reduced costs for receiving asylum seekers.³

Figure 4.2 Role of fiscal policy in stabilisation policy



Note: In BP18, the amounts are rounded for the various sub-components, so the sum of these items does not always match the change in structural net lending (the diamonds).

Source: BP18, Volume 1, Table 9.5, p. 730.

In general, the item “Miscellaneous” mainly consists of “automatic consolidation” of structural net lending. Public finances are automatically strengthened over time without the need for specific decisions. The increase in net lending arises as a result of generally rising revenues in line with nominal GDP, while expenditure increases more slowly in accordance with different regulations.⁴ In the event of trend growth and unchanged policy, the automatic consolidation increases structural net lending by about 0.5 per cent of potential GDP per year.⁵ Without this consolidation, net lending would have continually been weakened during the period 2017–2020, as the Government’s active measures during these years will weaken net lending by about 0.4 per cent of potential GDP per year. We note again that this active weakening is being done during a boom. Active fiscal policy is therefore procyclical. It should also be noted that the automatic consolidation of structural net lending presented for the

³ See Govt. Bill 2017/18:1, Table 9.6, p. 730.

⁴ For a discussion, see the Fiscal Policy Council (2011) pp. 72–79.

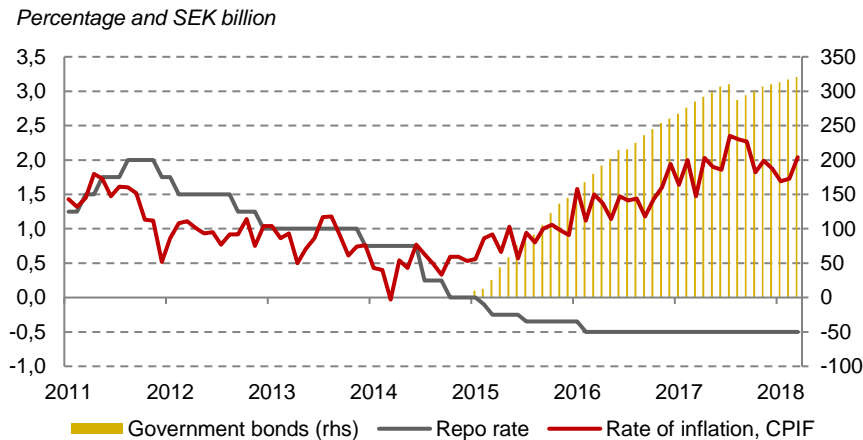
⁵ See the Swedish National Financial Management Authority (2013).

years 2019–2020 is unlikely to be realised.⁶ We know from experience that the Government regards this budgetary consolidation as reform space.⁷ If this space is utilised, structural net lending is weakened to a corresponding extent unless income is simultaneously strengthened.

4.4 Fiscal policy in relation to the particularly expansive monetary policy

The Riksbank’s task is to try to keep inflation close to the target of 2 per cent while at the same time striving to stabilise production and employment to achieve long-term sustainable development in these areas. In view of, inter alia, weak development in the rest of the world, the Riksbank has for a long time pursued a very expansive monetary policy to stimulate demand and raise inflation to the target level. The base rate has been negative since February 2015, and the Riksbank has also purchased government bonds to a large extent with the aim of raising inflation in the economy (see Figure 4.3).

Figure 4.3 Inflation, repo rate and government bonds on the Riksbank’s balance sheet



Note: CPIF monthly values.
Source: Sveriges Riksbank.

⁶ Fiscal Policy Council (2017) Chapter 3.4 and 3.5, and the Swedish National Financial Management Authority (2018) p. 54.
⁷ Fiscal Policy Council (2011) p. 2.1.1.

The Riksbank's expansive monetary policy has contributed to the recovery of the economy and has sparked a rise in inflation. Inflation has been close to the target for some time, and the Riksbank assesses – as do the Government and NIER – that resource utilisation is higher than normal. However, the Riksbank is of the opinion that a continued high level of activity in the economy is needed for a lasting stabilisation of inflation at around 2 per cent, and has therefore decided to keep the repo rate unchanged at -0.50 per cent. In April, the Riksbank announced that slow increases in the repo rate will be initiated towards the end of 2018.⁸ Furthermore, the Riksbank's net purchases of government bonds will continue, although it has been signalled that the scale of this quantitative easing will soon be reduced.⁹

As we have seen in Section 4.3 above, the active fiscal policy has also been expansive in recent years. It further stimulates the activity level in the economy. The Government notes in VP18 that resource utilisation is higher than normal, but ascertains that fiscal policy is nevertheless well balanced from a stabilisation policy perspective. The Government is of the opinion that the Riksbank's ability to further stimulate the economy has for some time been limited and that fiscal policy plays an important role in maintaining high resource utilisation. In the absence of price and wage inflation, the Government suggests that high resource utilisation facilitates rapid entry into the labour market for people who have recently been granted a residence permit, and improves job prospects for others with weak position in the labour market. The Government therefore rejects a "heavily restrictive fiscal policy".¹⁰

We share the Government's assessment that high resource utilisation facilitates rapid entry into the labour market for those who have recently obtained a residence permit and those with weak position in the labour market. We also share the Government's assessment that there are currently few signs that wages and prices are generally rising too fast. Nor do factors such as high household savings and surpluses in the balance of payments indicate that there are currently problematic imbalances in the economy. We therefore do not advocate severe austerity measures. On the other hand, we

⁸ Sveriges Riksbank (2018).

⁹ See Sveriges Riksbank (2017a) and Sveriges Riksbank (2017f).

¹⁰ VP18 p. 38.

want to emphasise that the high level of activity means that the expansive fiscal policy is increasing the risk of overheating, and associated problems, and reduces the space for fiscal stimuli in the future if resource utilisation would be too low. We also conclude that there is no need at present to help the Riksbank achieve its inflation target with an expansive fiscal policy.

4.4.1 Is the economy at risk of overheating?

Overheating usually means such a high level of resource utilisation that it causes accelerating inflation and wage growth rates.¹¹ In Sweden, however, there are currently no signs of excessive price and wage growth. Excessive resource utilisation can also result in the misallocation of resources and excessive risk taking with over-investment in certain sectors. The rapid growth in housing investment in recent years and up until quite recently may be an example of this (see section 1.3). Furthermore, households can become overoptimistic and consume too much, i.e., save too little, which can lead to a sharp drop in consumption in the next recession. However, households' savings ratio is historically high and households estimate themselves that they will continue to save more than usual in the coming year.¹² Excessively low household savings therefore do not seem to be a concern at the present time.¹³

Overall, we can note that the current high resource utilisation has not led to any more serious problems in terms of inflation and imbalances in different markets. At the same time, it is likely that the current economic boom has helped many people access the labour market, including those who, under normal circumstances, find it hard to get work. Both in the short and long term, this entails welfare gains for the individual and society. It also benefits public finances as tax revenues are increasing and unemployment-related expenditure is decreasing. It also has desirable long-term effects on the economy. Research shows that temporary exclusion from the labour market is likely to cause unemployment to become fixed at high levels for an extended period. This can be explained by the fact that individuals'

¹¹ See, for example, Ball (2015), OECD (2002), IMF (2017a), Sveriges Riksbank (2017d) and BP18.

¹² Economic Barometer, February 2018.

¹³ Also refer to the in-depth analysis "Is activity in the Swedish economy too high?" in Sveriges Riksbank (2017d).

skills and knowledge become dated or forgotten while unemployed.¹⁴ Another explanation is that the search behaviour of people can change after a period of unemployment because confidence in their own ability is weakened. In addition, the insider-outsider problems that naturally characterise the labour market contribute to exclusion from work.¹⁵ The Government's argument that a continued expansive economic policy counteracts exclusionary effects is therefore relevant.

Another argument for an expansive fiscal policy that has been presented has to do with the level of equilibrium unemployment. NIER and the Riksbank have been criticised for overestimating this level. According to this reasoning, economic policy should remain expansive in order to "test" where the lower limit of unemployment actually is.¹⁶ We ascertain that this argument is not convincing. The risks associated with "testing limits" are too great to be worth trying out this strategy. The negative effects on price and wage formation of an overly expansive monetary policy come with a time lag. If it turns out that the Riksbank's estimate of equilibrium unemployment is correct, the economic costs associated with regaining control of inflation and inflation expectations will become significant in such a "test".

The Council welcomes a report from the Government where it argues for an expansive fiscal policy from a stabilisation policy standpoint. The arguments submitted by the Government are important to consider when designing policy. However, we are lacking a discussion on the possible risks of pursuing an expansive fiscal policy in the current economic climate. We suggest that the Government's discussion of stabilization policy considerations should include both the risks and benefits of the proposed policy.

We can conclude that the Government's fiscal policy has for many years weakened general government net lending, despite there currently being a boom. This policy is continued and strengthened in BP18 and the Spring Fiscal Policy Bill 2018. This is not in line with the fiscal policy guidelines contained in both the old and the new

¹⁴ Ball (2009).

¹⁵ See, for example, Lindbeck and Snower (1984) or Blanchard and Summers (1986).

¹⁶ This argument is put forward by the IO economist Åsa-Pia Järliden Bergström and Niklas Blomqvist, doctoral student at Stockholm University, in a post on Ekonomistas on 10 January 2018. A recent critique of equilibrium unemployment is "NAIRU: not just bad economics, now also bad politics" by Matthew Klein in the Financial Times, 24 January 2018.

framework document.¹⁷ These guidelines have been designed to enable an active fiscal policy to be pursued while at the same time achieving the surplus target. In the political agreement which was the basis for revision of the fiscal framework last year, it is clear that the surplus target can only be reached if active economic stabilisation fiscal policy in a recession is matched by active consolidation measures when resource utilisation is high during a boom.¹⁸ We suggest that the Government has, during the current boom, wildly disregarded the surplus target in the cyclical adjustment of fiscal policy. The indicators – retrospective ten-year average and the seven-year indicator – presented by the Government in BP18 are far below the applicable target level. The new eight-year indicator is also below the new target level of 1/3 per cent of GDP in 2019 (see Table 2.5). This shows that during the boom of recent years, fiscal policy has not compensated for the deficit that emerged in the wake of the financial crisis.

Our opinion is that the Government's fiscal policy poses a risk that fiscal policy in a future recession may need to be tightened to meet the surplus target and thus remain procyclical. If such a tightening is not implemented, despite the surplus target not being reached, there is instead a risk that confidence in the surplus target will be undermined.

In the 2017 report, we argued that in the current situation, when households have good income and high savings at the same time as interest rates are low, a gradual increase in property tax (property charge) combined with a gradual reduction in interest deduction could be initiated without threatening continued healthy economic development. We still ascertain that these measures are well-founded, both from a structural and a cyclical perspective. Nor do the measures in any great way impair the Riksbank's ability to reach the inflation target, and they would also help reduce the risks of rapidly rising asset prices and indebtedness, something which the Riksbank has repeatedly called for.

¹⁷ Skr. 2017/18:207 pp. 13–16.

¹⁸ SOU 2016:67, p. 340.

Box 4.1 Two votes for a more expansive fiscal policy and the Council's opinion

Since the 2014 report, the Council has criticised the Government for pursuing an overly expansive fiscal policy. The Government has consistently rejected the Council's criticism, *inter alia*, with reference to the suggestion that the "tightening of fiscal policy would lead to further pressure on monetary policy", and that such a tightening "could increase the risks associated with household indebtedness".¹⁹ The Council does not share the Government's assessment. To further elucidate the issue of whether fiscal policy is too expansive, the Council asked two internationally prominent researchers who have written about the coordination between fiscal and monetary policy, Eric M. Leeper and Simon Wren-Lewis, to give their views on the mix of fiscal and monetary policy in Sweden in the prevailing economic climate. Leeper has written a report to the Council and Wren-Lewis has discussed the matter with the Council.

Leeper points out that the inflation target and surplus target have been formulated without regard to whether it is possible in all situations to achieve both targets simultaneously. Leeper suggests that there is a risk that situations may arise where it is impossible for the Riksbank to reach the inflation target if the Government maintains the surplus target. Such a conflict of objectives could look as follows: The Riksbank lowers the interest rate to raise inflation. A lower interest rate also means lower returns on government bonds, i.e., the interest expenses for the State decrease. This means that financial net lending increases and fiscal policy is tightened. According to Leeper, a prerequisite for a successful expansive monetary policy is that fiscal policy is not tightened but rather becomes more expansive, otherwise interest rate cuts will not result in higher inflation. With interest rate cuts, holders of bonds become poorer when yields on bonds decline and will therefore consume less. The lower demand that this results in will counteract the Riksbank's attempt to raise inflation. An increase in inflation, according to Leeper, also requires fiscal policy to become expansive.

Wren-Lewis notes that the Swedish monetary policy has for a couple of years entailed a negative base rate and quantitative easing. Nevertheless, inflation has not really reached the target level. There

¹⁹ Govt. Bill 2016/17:1 p. 586.

are currently no signs of overheating in the form of high wage and price increases. Wren-Lewis suggests that a lack of coordination between the Riksbank and Government, together with the surplus target, currently constitute an obstacle for economic policy. If fiscal policy could explicitly be coordinated with monetary policy, it should now be made even more expansive in order to bring inflation up to the target level and sustain this level. This can be done through measures that are temporary, i.e., relatively easily reversible when the situation has become more normal, for example, through temporary tax cuts. Wren-Lewis suggests that the Government should therefore now ease the surplus target. The fact that there is a general and growing shortage of labour in the economy, and that, for example, the manufacturing industry and the construction industry are hitting the capacity ceiling, does not constitute a barrier to a more expansive fiscal policy. The strained situation attracts investments that provide higher growth and more resources for private and public consumption. According to Wren-Lewis, a more stimulating fiscal policy would lead to inflation rising to the target level and to improving long-term growth prospects through increased investment.

The Council's views on the arguments for an expansive fiscal policy as proposed by Eric Leeper and Simon Wren-Lewis are as follows: We note that Leeper's reasoning assumes that all other known channels through which interest rate changes affect demand in the economy are completely dominated by the mechanism described by Leeper. We do not agree with this. We also note that a prerequisite for the target conflict alluded to by Leeper as constituting a stabilisation policy problem is that there is significant public-sector net debt. In Sweden, since the mid-2000s, the public sector has instead had net wealth, which today amounts to about 25 per cent of GDP. The mechanism on which Leeper bases his reasoning is therefore not relevant. The Council is also of the opinion that there are very strong reasons to respect the surplus target also in the current situation. There will always be arguments in favour of deviating from the surplus target. In a recession, there are arguments for increasing the deficit and during a boom, there are arguments for not ensuring sufficiently large surpluses. This decision-making tendency is the root cause for introducing fiscal policy

regulations within OECD in the early 1990s.²⁰ In our opinion, Wren-Lewis places too much importance on the inflation target when arguing for the abandonment of an independent Riksbank and surplus targets in fiscal policy because inflation has been a few tenths below the inflation target for a while.

Source: Leeper (2018) and a conversation with Simon Wren-Lewis, University of Oxford, via Skype on 23 October 2017.

4.5 Assessments and recommendations

The main responsibility for the active stabilisation policy lies with the Riksbank. The contributions of fiscal policy to the stabilisation of the economy should be by way of the automatic stabilisers.

At present, the fiscal policy does not need to support the monetary policy. Since 2016, the fiscal policy has been expansive and procyclical; the net lending has been gradually weakened in a situation where resource utilisation has been higher than normal. At the same time, the level of structural net lending during the current boom is low in relation to the target level. The fiscal policy thereby contributes to the boom and the risk of overheating, while it reduces the future scope for active measures to stabilise the economy.

Our opinion is that the Government's fiscal policy poses a risk of having to tighten the fiscal policy in a future recession in order to meet the surplus target and thus remain procyclical. If such a tightening is not implemented, despite the surplus target not being reached, there is instead a risk that confidence in the surplus target will be undermined.

²⁰ SOU 2016:67 pp. 109–116.

5 Labour market

One of the Council's tasks is to assess whether the economic policy leads to a high level of employment in the long term. In this chapter, we look at how the labour market has developed in light of the implemented policy. We initially discuss the formulation of the Government's unemployment target and the conditions of reaching this target through increased employment based on current policy and the function of the labour market.¹⁶⁰

The Council is also tasked with reviewing and evaluating the Government's forecasts.¹⁶¹ It is especially important for the Council to analyse the forecasts that form the basis of the assessment of general government net lending over the coming years, as these impact on the follow-up of the surplus target. In BP18, the Government lowered the prognosticated level of unemployment for 2018 by half a percentage point compared to VP17, in reference to the new policy. The Government's forecast deviated quite a bit from that of most other analysts, and we will look at this forecast in more detail. The forecasts for unemployment and equilibrium unemployment are central to the assessment of net lending, as they impact on expenditure (unemployment benefits) and income (more people employed entails a greater tax revenue). As detailed in Chapter 2, there is a relatively large difference in the views of NIER and the Government when it comes to structural net lending in the coming years. Our assessment is that a large part of this different consists of differing views on the labour market development.

5.1 Difficulty reaching the target despite a strong labour market

5.1.1 Unemployment target

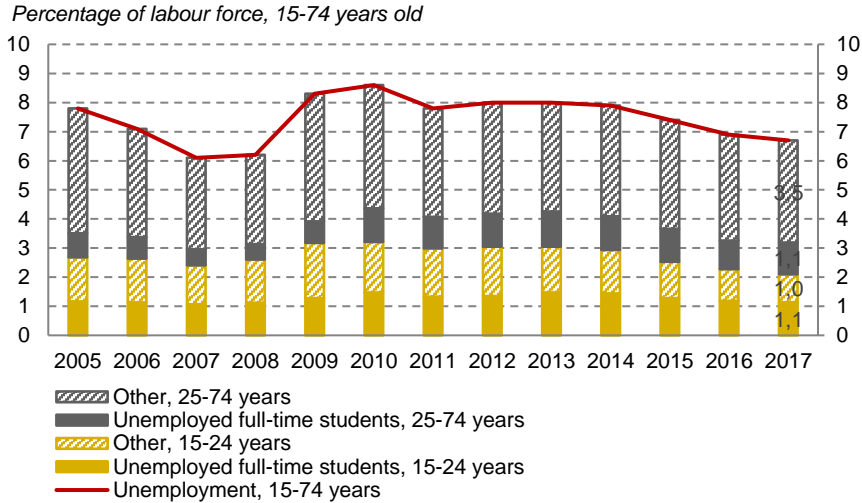
The Government is guided by the goal of having the number of individuals working and the number of hours worked in the economy increase to an extent that gives Sweden the lowest level of

¹⁶⁰ The main characteristics of the Government's policy concerning the labour market during this term are described in appendix 1.

¹⁶¹ The Council Report 2017 included an evaluation of a number of central forecasts. See Fiscal Policy Council (2017).

unemployment in the EU by 2020.¹⁶² It would be positive to attain this goal through increased employment; however, the Council expressed criticism already in its report of 2015 of the goal being set in relation to the other EU countries, arguing that it would be difficult to achieve. One reason is that a relatively large proportion, compared to other EU countries, of the unemployed in Sweden, approximately one third (Figure 5.1), consists of full-time students. The high proportion is to an extent related to structural factors in the education systems.¹⁶³

Figure 5.1 Proportion of young people and full-time students in unemployment



Note: The red line shows the number of unemployed as a percentage of the labour force aged 15–74 years. The bars show the respective proportion of the unemployment for each group, stated as a percentage. In 2017, for example, 1.1+1.1=2.2 percentage points of a total 6.7 per cent consisted of full-time students.

Source: Statistics Sweden (AKU).

A comparison of different countries’ unemployment is also made more difficult by the fact that their economic situations may differ at any given time. For this reason, a comparison is often made between the structural unemployment levels, i.e. the equilibrium

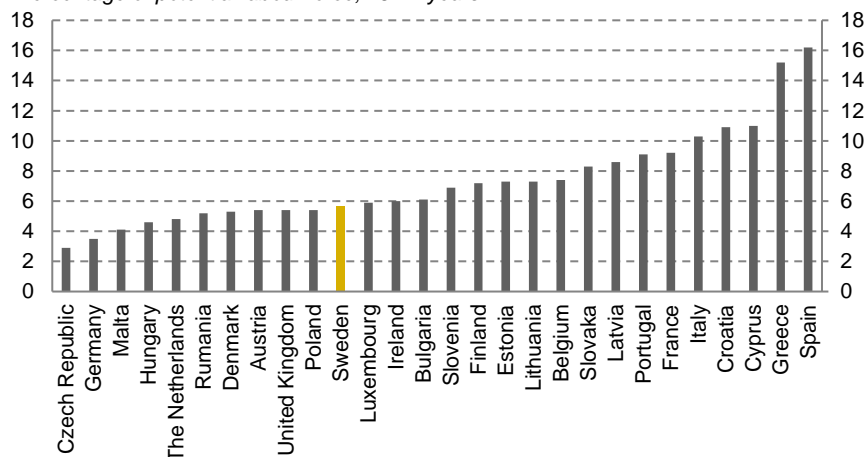
¹⁶² BP15 p. 38.

¹⁶³ For example, those who complete an apprenticeship during upper secondary school in Denmark and Germany receive a salary already in school and are consequently considered employed, while a young person in Sweden in an equivalent programme does not receive a salary and is therefore not considered employed. See Fiscal Policy Council (2015) p. 87–89 and Fiscal Policy Council (2014) section 3.4 for a discussion on international comparisons of the young person’s labour market.

unemployment. The Council has previously noted that there is still a significant difference between Sweden and those countries in the EU with the lowest unemployment even after eliminating the differences in economic situation. The distance to the countries with the lowest equilibrium unemployment is 2.9 percentage points, according to the latest figures from the European Commission.

Figure 5.2 Structural unemployment in the EU

Percentage of potential labour force, 15–74 years



Note: The European Commission uses an estimation by NAWRU to assess the equilibrium unemployment. See Havik et al. (2014) for a method description.

Source: European Commission (2017).

The large influx of refugees in 2015–2016 has created further challenges in forcing down both actual and structural unemployment in the next few years. It is only normal that it takes some time to become established in the labour market in a new country. The employment rate is therefore significantly lower among those who have been in Sweden for a short time.¹⁶⁴ An increasingly strong economy has contributed to this establishment now being somewhat faster than before, but it will take time for the economy to adjust in order to utilise the new resources to create growth and jobs.¹⁶⁵ The large increase in the labour supply in later years due to immigration is thereby deemed to have a restraining effect on the employment rate

¹⁶⁴ See Fiscal Policy Council (2017) p. 117–119 for employment rate according to ethnicity, residence period and education.

¹⁶⁵ Previously, the employment rate was around 50 per cent after 10 years in Sweden; however, out of those who arrived in 2011, nearly half had a job after 5 years. See VP18 p. 41.

in future. However, there is uncertainty in how well these individuals are captured in the statistics. The reason for this is that there is a great lag in the statistics as the result of the selection procedure for the Labour Force Surveys (box 5.1).¹⁶⁶

Box 5.1 More uncertainties than usual in the statistics

The refugees who arrived in Sweden in 2015–2016 are now starting to enter the labour market. However, as a result of the selection procedure in AKU, there is a significant lag in the official statistics. AKU is a selection survey. The selection is made in November each year from the Total Population Register (TPR). Those selected are gradually rotated in AKU as of January in the following year and then participate in the survey for two years.¹⁶⁷ The sample of the population on which AKU is based consequently does not correspond fully to the individuals registered in the population register at the time referred to by the survey, since part of the selection can have been made up to three years prior to the survey being answered. However, each month, the weight of AKU's monthly samples is updated and adapted to the population according to TPR. During periods of great population changes, for example resulting from immigration, foreign-born individuals taking part in AKU in a year will represent a growing group within the population. But the residence period of foreign-born individuals within the sample tends to be longer than that in the actual population, which can mean that the employment rate is overestimated for some time before the statistics “catch up” to fully illustrate the changes.

Newly arrived migrants are registered more quickly in the operational statistics of Arbetsförmedlingen (AF).¹⁶⁸ AF reports register-based data about individuals who are registered with them. Since 2010, AF has been the coordinating authority for the establishment of new arrivals on the Swedish labour market (through the establishment programme).¹⁶⁹ Despite differences in terms of both the definition of the term unemployed and which individuals it

¹⁶⁶ NIER (2017f) p. 34–35 and Statistics Sweden (2017).

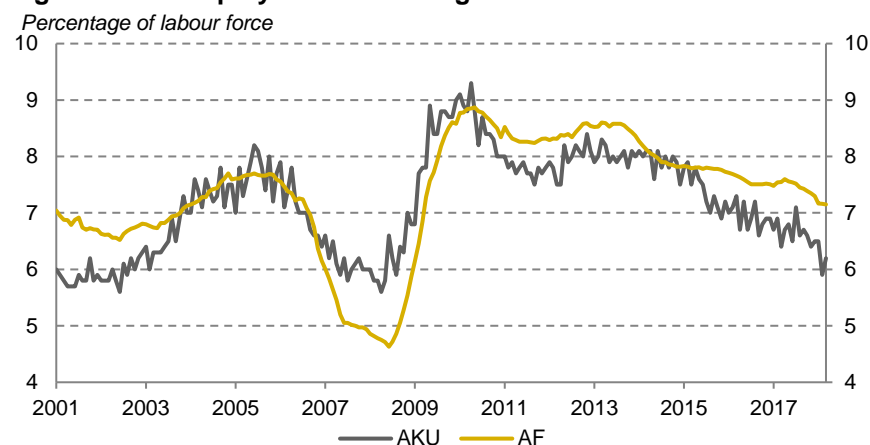
¹⁶⁷ In theory, those who were granted residence permits prior to September 2017 will start their rotation in AKU in January 2018. However, it will be a number of years before the official statistics have caught up.

¹⁶⁸ See Arbetsförmedlingen (2017b) p. 50.

¹⁶⁹ Act (2010:197).

includes¹⁷⁰, the two measurements have historically be surprisingly concordant regarding the level of unemployment. In later years, there has been a significantly smaller decrease in unemployment rates in operational statistics of Arbetsförmedlingen (AF) compared to the figures from AKU (Figure 5.3). This is due in part to the statistics catching unemployed new arrivals earlier, and in part to AF's operational statistics using a register-based labour force when reporting the proportion of registered jobseekers, which is different from that used in AKU.¹⁷¹ This difference may mean that the proportion of unemployed is overestimated in times of rapid growth in the labour force.

Figure 5.3 Unemployment according to AKU and AF



Note: AKU refers to unemployment in the group aged 15–74 years. AF refers to Arbetsförmedlingen's operational statistics, openly unemployed and jobseekers in programmes, 16–64 years old.

Source: Arbetsförmedlingen, Statistics Sweden and Macrobond.

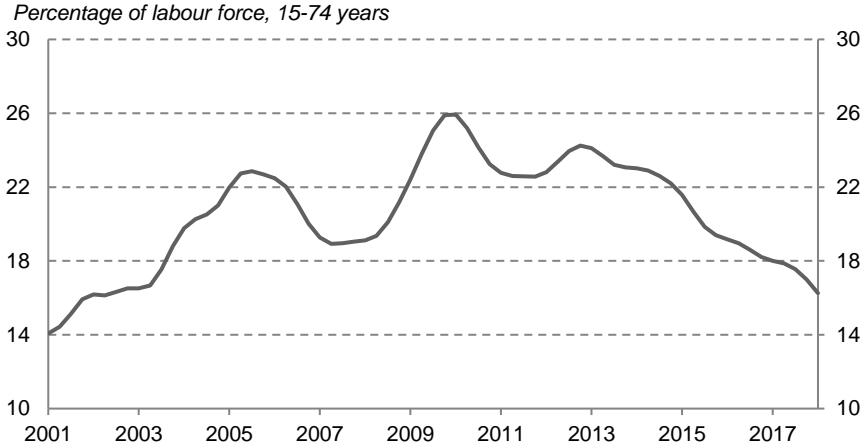
In general, there has been good development in the Swedish labour market in later years. Since 2014, the employed population has increased by approx. 250,000 people. As the economy is growing stronger, unemployment has gone down, but the decline has been moderate in relation to the employment development (from 7.9 per

¹⁷⁰ Statistics Sweden (2016).

¹⁷¹ In the AF statistics, the labour force is the sum of the active working population (in accordance with Statistics Sweden's Labour statistics based on administrative sources, RAMS) and those openly unemployed seeking work through programmes with activity support (registered with Arbetsförmedlingen). The data concerning the number of gainfully employed individuals refer to November in the last available year, while the information regarding number of jobseekers is updated monthly.

cent in 2014 to 6.7 per cent in 2017) as the labour force has also grown significantly. Unemployment among young people, aged 15–24 years, has seen a noticeable decline in the last few years, and it is now lower than during the last cyclical peak in 2007 (figure 5.4).

Figure 5.4 Unemployment among young people aged 15–24 years



Note: Seasonally adjusted and equilibrated quarterly values.
Source: Statistics Sweden (AKU).

Despite the positive employment development, Sweden has fallen in the EU rankings of unemployment, from twelfth place in 2014 to a shared fifteenth place in 2017 (figure 5.5). Considering the formulation of the goal to have the lowest rate of unemployment in the EU, it therefore appears as if the Government’s policy has been insufficient. But a target formulated as a quota (unemployed/labour force) and in relative terms (compared to other EU countries) risks being misleading. The Czech Republic, which had the lowest unemployment in the EU in 2017, has a significantly lower labour force participation than Sweden; the difference is 7 percentage points. Even Germany, which was in first place in terms of unemployment in 2014 and second in 2017, has a labour force participation that is 3.2 percentage points lower than that of Sweden.¹⁷² A high degree of participation is essentially positive; however, one consequence of the high degree of participation in

¹⁷² In addition to a lower labour force participation, a larger number of full-time students are considered to be employed in Germany compared to Sweden, which is due to differences in the education systems. Both of these factors contribute to a lower measured unemployment level in Germany than in Sweden.

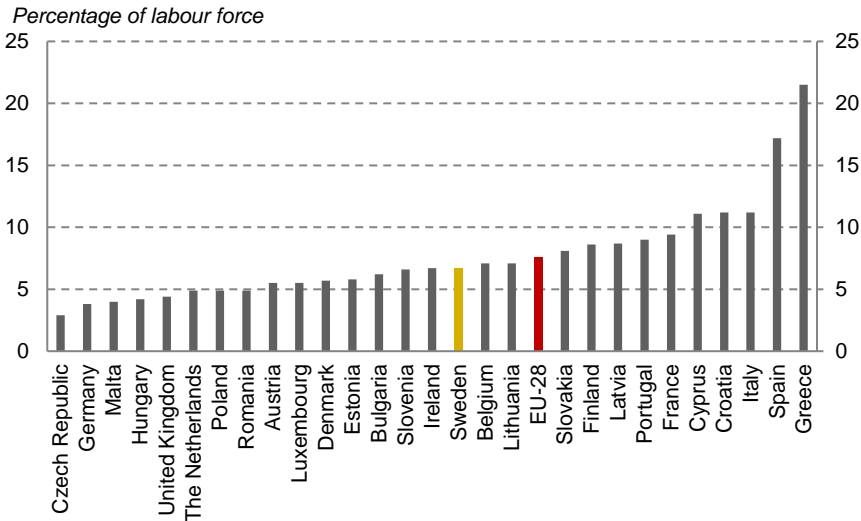
Sweden is that the labour supply also includes individuals with relatively weak prospects in the labour market. In the EU countries where labour force participation is lower, individuals with small chances of finding a job are likely more prone to remain outside the labour force.

If a comparison is instead made of how large a proportion of the population that is actually employed, a completely different picture emerges. Despite a deteriorated ranking in terms of unemployment, the employment rate in Sweden is still the highest in the EU (sharing first place with Estonia), at one percentage point higher than in Germany and four percentage points higher than in the Czech Republic (Figure 5.6). The employment rate has risen in later years and, according to AKU, it amounted to 67.8 in the population aged 15–74 years in 2017.

As a tangible guide to the economic policy, the Government's unemployment target is problematic, as steps towards (or away from) the target could equally be due to the domestic development as to that of the EU in general. The formulation means, for example, that there is no cause to believe that the strong domestic economic trend will bring Sweden that much closer to the goal. As it appears that the economic trend is now seriously turning upwards in the rest of the EU, it is not unlikely that Sweden's position in the unemployment ranking will deteriorate further.

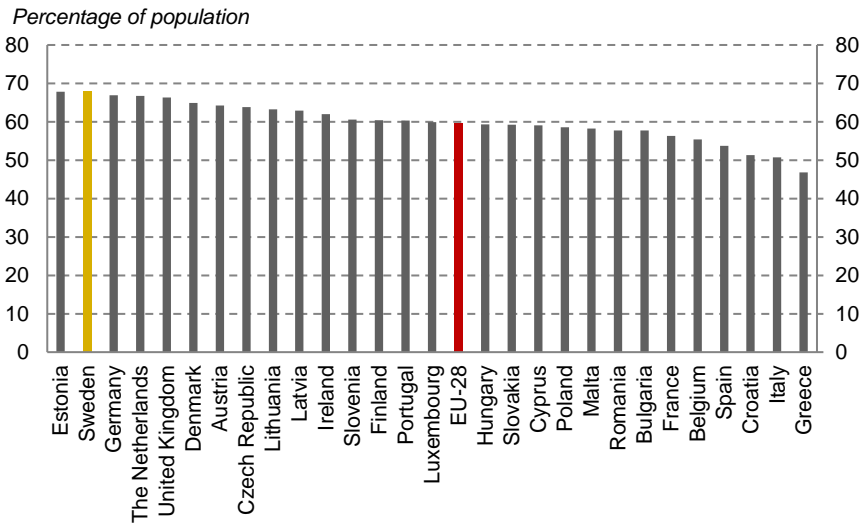
We are therefore still of the opinion that the policy targets for the labour market should be formulated in a way that makes it possible to evaluate them based on domestic developments and policies. The target(s) should also be formulated to be closely linked to the problems that exist in the labour market. In both BP18 and VP18, the Government discusses several such challenges. In particular the labour market prospects of those with no upper-secondary education, those born outside of Europe and especially the establishment of newly arrived women in the labour market, but also challenges relating to rectifying shortages in certain professions and sectors through education. The Council is of the opinion that it would be more appropriate to formulate the employment and unemployment targets based on these problems.

Figure 5.5 Sweden is falling in the ranking of unemployment...



Note: Data refers to 2017, group aged 15–74 years.
Source: Eurostat and Macrobond.

Figure 5.6 ...but has the highest employment rate in the EU



Note: Data refers to 2017, group aged 15–74 years.
Source: Eurostat and Macrobond.

5.1.2 Many find it difficult to enter the labour market

While Sweden has the highest employment rate in the EU, the Swedish labour market is characterised by large differences between different groups. The group that finds it the hardest to enter the labour market are those without an upper-secondary education and those born outside of Europe (Figure 5.7). The employment rate among native-born individuals aged 25–54 years with post-secondary education is nearly 93 per cent. The corresponding figure for people born outside of Europe is approximately 20 percentage points lower. It is also troublesome that the employment rate in this group has remained close to unchanged in later years, and it has shown no signs of increasing. The difference between native and foreign-born individuals is even greater for those with the lowest qualifications. A little less than half of the people born outside of Europe with no more than upper-secondary education were employed in 2017, while nearly three quarters of the native-born individuals with the same level of education were employed.

Figure 5.7 Employment rate according to origin and education in core labour force aged 25–54 years

a) Primary and secondary education

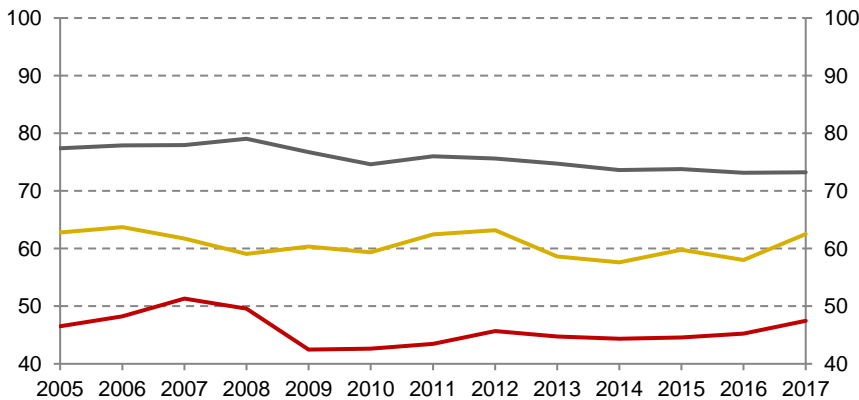
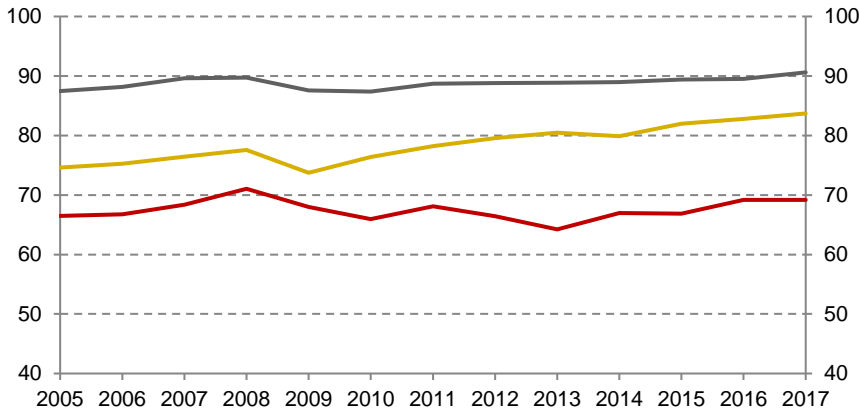
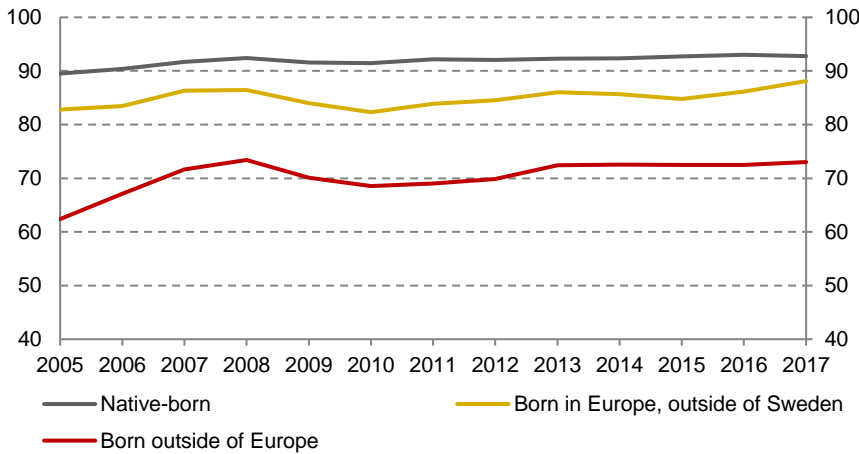


Figure 5.7 Employment rate according to origin and education in core labour force aged 25–54 years (cont'd)

b) Upper-secondary education



c) Post-secondary education

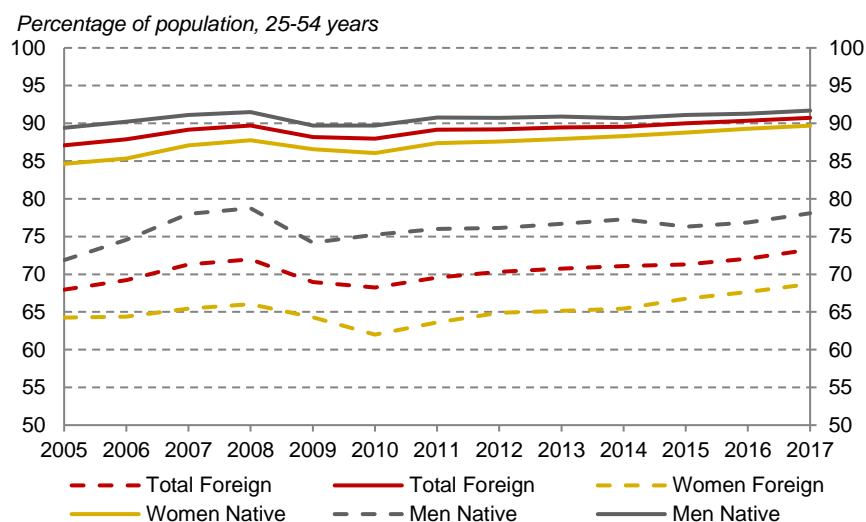


Note: Percentage of the labour force, 25–54 years old.
Source: Statistics Sweden (AKU) and own calculations.

There are also large differences between women and men. From an international perspective, the employment rate among women is very high in Sweden. This applies primarily to native-born women, where the employment rate in the ages 25–54 in 2017 amounted to 89.7 per cent (Figure 5.8). The employment rate among foreign-born women is significantly lower, at 68.7 per cent. In the last few years, this figure

has risen and is now higher than prior to the financial crisis, but the gap compared to the native-born women is still wide.

Figure 5.8 Employment rate according to origin and gender in core labour force aged 25–54 years



Source: Statistics Sweden (AKU).

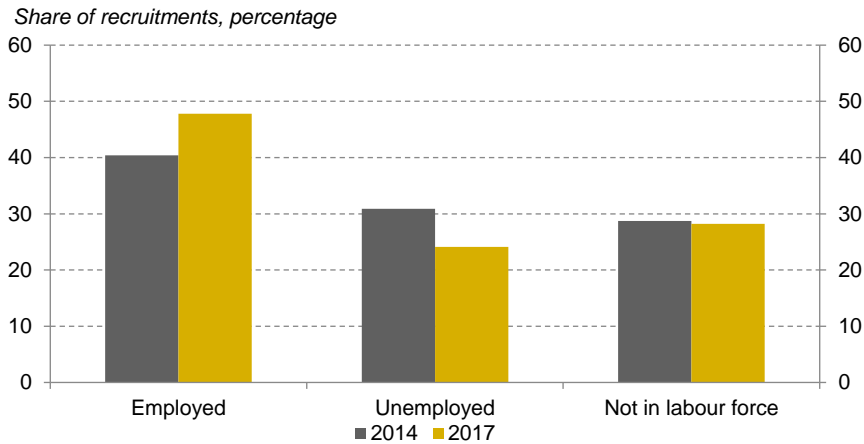
The future development, where many individuals with a relatively short residence period become available in the labour market, entails a risk that the large differences between native and foreign-born women and men will remain or grow unless extensive targeted measures are taken to improve integration.

5.1.3 Imbalances in the labour market

While unemployment remains at a high level in many groups, there is a great shortage of labour in both the private and public sectors. The job vacancy rate, i.e. the number of vacant positions in relation to the labour force, is high and the recruitment periods in the private sector are long, which would indicate that it has become increasingly difficult for companies to find the staff they are looking for (see chapter 1). This has also led to the proportion of recruitments being carried out among those who are already employed increasing to nearly half of all recruitments in 2017. At the same time, the proportion of recruitments carried out among the unemployed has

been reduced by approximately 7 percentage points since 2014 to a little under one fourth of all recruitments in 2017 (Figure 5.9). The development reflects the fact that the group “unemployed” now consists of individuals who lack the skills being sought and that the conditions for matching the unemployed person with existing jobs have deteriorated.

Figure 5.9 Recruitments according to previous labour force status

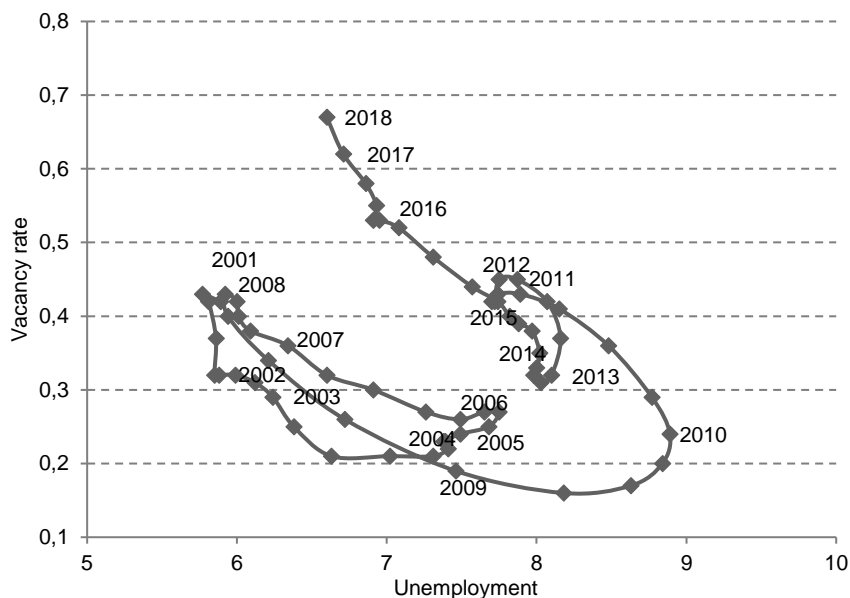


Note: Externally recruited, distributed by labour force status in the preceding quarter, annual average.
Source: Statistics Sweden.

Another way to illustrate the success of matching in the labour market is to use the Beveridge curve, which shows the correlation between unemployment and job vacancy rate (Figure 5.10). Normally, there is a negative correlation between vacancies and unemployment, meaning that unemployment goes down as the job vacancy rate rises, and vice versa. If the job vacancy rate rises without a decline in the unemployment, the curve will shift outwards, which can be a sign of deteriorated matching conditions in the labour market. The further away from the origin the curve is, the less the matching of unemployed individuals and job vacancies is working. There was a shift of the Beveridge curve away from the origin in several countries, including Sweden, in conjunction with the financial crisis. However, such a shift may also be part of the economic cycle or occur as the result of it taking time for the labour market to absorb the labour force when the supply increases rapidly. Theory and empirical experiences from different countries show that cyclical

fluctuations result in job vacancy and unemployment variations that can be illustrated as anticlockwise loops in the Beveridge curve. These loops can be explained by a persistent unemployment that reacts with a time delay to an improved vacancy situation. In later years, the job vacancy rate in Sweden has risen steadily and is now at a historically high level. However, unemployment has not decreased to a corresponding extent. It is likely that the shift in the Beveridge curve that occurred in conjunction with the financial crisis is, at least partially, a matter of a normal cyclical progression, but the “loop” shows no signs of closing, which would indicate that there may be more permanent matching problems.

Figure 5.10 Beveridge curve



Note: The year markings indicate the first quarter of each year. The job vacancy rate is calculated as the number of vacancies (according to Statistics Sweden) as a proportion of the labour force.

Source: Statistics Sweden and own calculations.

The effectiveness of the matching on the labour market can also be described using matching functions.¹⁷³ In its simplest form, the matching function is estimated based on aggregate data, where the likeliness of finding a job is related to the number of job vacancies in

¹⁷³ Matching function based on the theories of Diamond, Mortensen and Pissarides. See, for example, Pissarides (2002).

relation to the number of jobseekers.¹⁷⁴ This correlation has been empirically proven to be a fair approximation of the matching on the labour market in normal circumstances, but it is much less accurate in harder times with large fluctuations in the labour market.¹⁷⁵ One reason for this is that the matching function does not capture the effects of changes to the composition of the group “unemployed”. Over the last decade, the proportion of individuals with a weak standing in the labour market has increased markedly.¹⁷⁶ In addition to the cyclical effect, this increased proportion is also due to policy measures to increase labour force participation, changes to health insurance and the extensive immigration. A deep recession, which entails increased long-term unemployment, can also lead to poorer matching conditions in the long term. Long-term unemployment entails a risk of the individual losing human capital and eventually becoming less active in searching for jobs, which reduces the chances of finding one.

In later years, both AF and KI have regularly published estimations of the matching functions based on Swedish data.¹⁷⁷ These indicate that the chances of finding a job is now significantly lower than what the historic correlation with the job vacancy rate implies.¹⁷⁸ However, analyses of aggregate data cannot be used to adequately quantify the significance of the changes in composition. One of the Swedish National Audit Office’s recently conducted analyses instead uses individual data to decompose the change in the chance of finding a job over time. The results indicate that changes in composition can explain around one third of the deteriorated matching following the financial crisis.¹⁷⁹ The rest would thereby have other causes. In light of this, it is important to have a continued analysis of the labour market function, based on both aggregate and individual data, in order to be able to implement structurally appropriate reforms in the future.

¹⁷⁴ See, for example, Forslund and Johansson (2007) and Håkanson (2014).

¹⁷⁵ Barnicon and Figura (2013).

¹⁷⁶ The corresponding view is also given in Arbetsförmedlingen’s operational statistics, where three quarters of the jobseekers (openly unemployed and jobseekers in programmes) now come from groups with lower chances on average of finding a job, i.e. vulnerable groups. This proportion has increased by approx. 10 percentage points since 2014.

¹⁷⁷ The Fiscal Policy Council and the Riksbank have also previously analysed the matching conditions in the labour market, see Fiscal Policy Council (2012) Chapter 5.

¹⁷⁸ See Arbetsförmedlingen (2015, 2016 and 2017c) as well as NIER (2017b).

¹⁷⁹ Angelov (2017). However, the results are put into question in part by Arbetsförmedlingen, see Zetterberg (2018).

5.2 The Government's differential unemployment forecast in BP18

After the meeting in Harpsund in August 2017, the Government revised its unemployment forecast for 2018 onwards. In its press release, the Government wrote:

Unemployment is expected to fall further next year to 5.9 per cent. The downward revision is primarily due to the fact that most of the policies that will be presented in the coming Budget Bill are now included. This causes unemployment to be revised down by around 0.4 percentage points next year compared to the spring Budget Bill 2017. The total downward revision of unemployment since this spring is 0.5 percentage points.

The Council notes that the unemployment forecast differs from that of several other analysts. Table 5.1 shows the Government's forecast compared to a number of other analysts, domestic and international, in the autumn 2017. Among the latter, only OECD shared the Government's view. The others instead counted on the unemployment rate being approximately half a percentage point higher.

Table 5.1 Comparison of unemployment forecasts autumn 2017

	BP18	NIER	RB	ESV	EU Comm	IMF	OECD
2017	6.6	6.6	6.7	6.7	6.6	6.6	6.6
2018	5.9	6.3	6.5	6.5	6.4	6.3	6.0
2019	5.9	6.2	6.5	6.4	6.3	6.3	5.9
2020	5.9	6.3	6.5	6.5		6.3	

Note: Percentage of the labour force, 15–74 years old.

Source: BP18, NIER (2017a), Sveriges Riksbank (2017d), Swedish National Financial Management Authority (2017), European Commission (2017), IMF (2017c) and OECD (2017b).

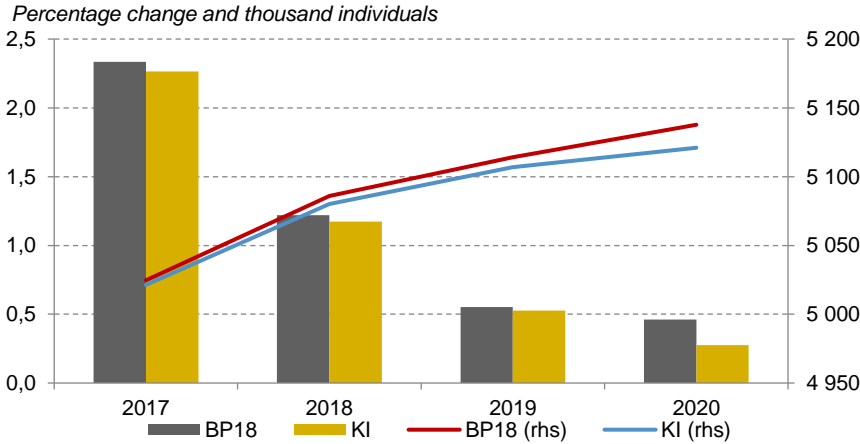
In other words, the long-term development is always highly uncertain, but the main difference in the view of unemployment arises already in 2018. The Government is of the opinion that the new policies in BP18 are behind the downwards revision of unemployment. NIER made the assessment that the new labour market measures will have limited effects on employment and unemployment in the short term.¹⁸⁰

¹⁸⁰ NIER (2017a) p. 74. Note that the Government's assessment also includes changes in the composition of fiscal policy, thereby making it a broader assessment.

Upon closer comparison between the labour market forecasts of the Government and NIER, we find that the development of the employment rate does not differ much for 2018 (Figure 5.11). The Government estimates that a little less than 6,000 individuals more will be employed compared to NIER. The difference in the view of unemployment for 2018 is due to a great extent to the Government forecasting a weaker development in the labour force compared to NIER. In the Government's forecast, the labour force growth comes to a sudden halt as of 2018, while it declines gradually in NIER's assessment (Figure 5.12).¹⁸¹

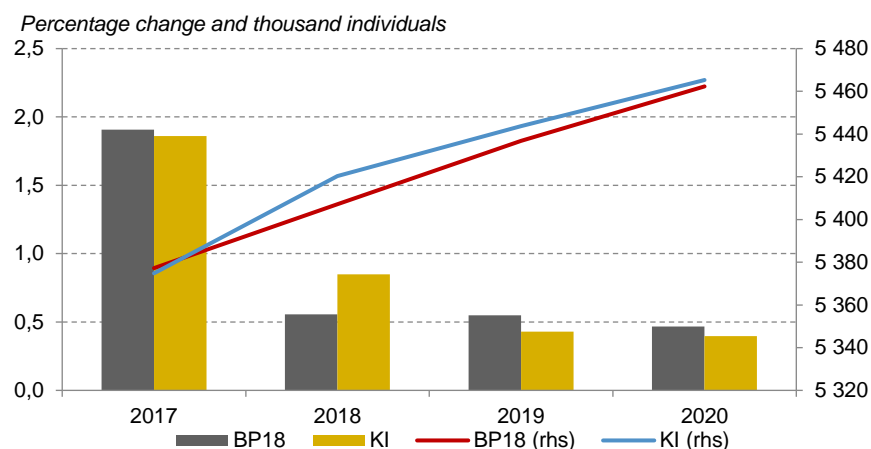
At the publication of BP18, the Government had access to statistics up to and including the second quarter of 2017. At that time, unemployment was at 6.6 per cent. The following is a discussion regarding the Government's unemployment forecast based on four points of departure: 1) the strength of the economy; 2) current policy; 3) an example of a simple calculation to illustrate what would be required in terms of employment rate in different groups; and 4) the view of equilibrium unemployment.

Figure 5.11 Employment development, forecast comparison



Note: Labour force growth, 15–74-year-olds, annual percentage change.
Source: BP18 and NIER (2017a).

¹⁸¹ According to the Government, the labour force is expected to grow at just under 0.6 per cent in 2018 (compared to 1.9 per cent in 2017). This corresponds to 13,000 fewer members of the labour force than in the NIER assessment.

Figure 5.12 Labour force development, forecast comparison

Note: Employment growth, 15–74-year-olds, annual percentage change.

Source: BP18 and NIER (2017a).

5.2.1 Are the contributions of the economy and the prevailing policy sufficient?

Fiscal policy affects the labour market in several ways: partly through measures which increase demand in the economy and the demand for labour, and partly through active labour market policy and structural changes on the labour market which affect unemployed persons' job-seeking habits and employer costs. In general, the labour market is improving in line with an increase in the demand for labour. The shortages in many sectors, not least the public sector, are currently at a historic high (see Chapter 1). The Government, along with a number of other analysts, also believes that the growth in the Swedish economy will remain steady in the coming years.

In BP18, the Government writes that the active fiscal policy is estimated to have increased GDP growth by approx. 0.5 percentage points per year during the period 2015–2017, making it the most important cause for the reduction of unemployment since this government came to power. More than half of the total decrease in unemployment is deemed to be attributable to the fiscal policy.¹⁸² This assessment is based on a rough calculation in which the Government has used the taxation of fiscal policy multipliers from

¹⁸² BP18 p. 36.

research literature. Effects on employment have then been calculated based on Okun's Law.¹⁸³ An equivalent calculation lies behind the downward revision of unemployment in BP18. A rough calculation of this kind can be illustrative and act as support for policy considerations. At the same time, it is important to be very cautious of drawing any "solid" conclusions.

One way of assessing the plausibility of the Government's unemployment forecast for 2018 is to use historical relationships between GDP and unemployment.¹⁸⁴ Based on the Government's forecasts with regard to GDP, potential GDP and equilibrium unemployment, we have extrapolated two variants of the estimated Okun relationship, which capture the co-variation between the GDP gap and the gap in unemployment (the deviation of unemployment from the equilibrium), as well as the change in GDP and unemployment. Both extrapolations indicate an unemployment rate of 6.5 per cent for 2018.¹⁸⁵ In light of this, the Government's forecast seems highly optimistic. At the same time, the relationships are simple and do not capture more than the estimated co-variation between GDP and unemployment. the Government's active labour market policy in BP18 is for example not captured beyond what is included in the GDP forecast, nor the effects of a change in the structure of the finance policy.

5.2.2 What effects can an active labour market policy contribute?

From a theoretical standpoint, the value of an individual's productivity must be at least as high as the labour cost in order for them to be employed. Minimum wages in various sectors may therefore constitute a floor which limits the labour demand – individuals whose productivity is lower are shut out from the labour market and the rate of employment is lower than it would be if the

¹⁸³ The calculation makes use of careful assessments of the multipliers estimated by KI at the Government's request. See Hjelm & Stockhammar (2017) and Ekholm & Gerlach (2017). The multiplier is deemed to be around 1 for increased public consumption and investments, around 0.75 for increased transfers to low-income households, around 0.5 for increased general transfers and income tax changes and around 0.25 for decreases in indirect taxes.

¹⁸⁴ As per Okun's Law.

¹⁸⁵ If KI's assessment of the GDP and unemployment gap is used instead, the extrapolation indicates a lower rate of unemployment, 6.2 per cent, which is mainly due to KI's assessment that the GDP gap is larger.

market forces could act freely. At the same time, there is cause to have some form of minimum wage; for example, to counteract income inequality and to ensure that it is possible to live on any given wage – aspects which have traditionally been important in Sweden. Minimum wages in the various sectors of the labour market are negotiated by the social partners. In order to lower the labour market entry thresholds, the Government can employ active labour market policies; partly by raising an individual's productivity through education, partly by reducing the labour cost for the employer using different types of subsidies.

During its term, the Government has implemented a number of changes in the taxation and transfer areas, and within the active labour market policy, which affects the workings of the labour market in various ways. New forms of support have come about and existing ones have been changed, all with the purpose of better reaching those who are farthest from the labour market. Other changes, such as those affecting unemployment and sickness benefits and income tax, are deemed to have an impact on the incentives to work.¹⁸⁶

The active labour market policy primarily affects those participating in the measures, but can also have consequences both for other employees and the labour market in a more general sense; e.g., via displacement and by influencing salary structure or the effectiveness of matching. The measures are intended to affect the individual's future labour market situation, through greater chances of receiving and retaining a job, higher productivity and a higher salary, for example. But participating in a programme may also delay entry to the labour market in that a lock-in effect occurs during the course programme and/or via a decrease in job-seeking activity. Previous evaluations of labour market training reveal that the long-term effects on salary and employment are small, or even negative.¹⁸⁷ These studies have however mainly focused on evaluation in a short-term perspective. A recently published study shows that the long-term effects of labour market training, up to ten years after commencing, are positive in terms of both employment and income.¹⁸⁸

¹⁸⁶ These are described in greater detail in Appendix 1.

¹⁸⁷ See Calmfors et al. (2002) and Forslund & Vikström (2011) for overviews of the field.

¹⁸⁸ See Vikström & van den Berg (2017).

Subsidised employment leads to displacement effects, either because the company in question would have employed the same person without the subsidy (deadweight loss effect) or because another person would have been employed (substitution effect).¹⁸⁹ Research findings indicate that the subsidised employments which are the most similar to conventional employment are those that work best in the long term in terms of finding steady employment, but that the displacement effects are great in general, at over 50 per cent. The problem with displacement can be limited, however, if the subsidies are targeted to those who to a lesser extent compete for existing jobs, such as the long-term unemployed and new arrivals. If employment support is formulated so that it reaches these groups, the total employment rate can be increased whilst at the same time the displacement effects are minimised.

It is also a matter of weighing how large and how permanent a subsidy should be. A shorter subsidy period limits the effect for the individual and reduces the incentives for the employer to carry out subsidised hiring; however, permanent measures are costly. Historically speaking, it has been difficult to achieve high volumes in different types of measures, even if the level of subsidisation has been very high. Possible reasons for this are that the level of knowledge on various subsidies is low among employers and that the subsidies are perceived as complex and as an administrative burden.¹⁹⁰

The conclusive question is how much people gain regular employment following subsidised employment. When the subsidy period is over, the value of the individual's productivity from the employer's perspective must exceed the total labour cost if they are to be offered permanent employment. For those with the lowest productivity, there is a lower probability that subsidised work will lead to a regular job in the long-term. In order for these individuals to achieve long-term stability, extensive training initiatives are necessary. However, there are probably many people who, even with extensive training initiatives, do not achieve a level of productivity which is sufficiently high to attain permanent, unsubsidised employment. One consequence of high minimum wages and compressed wage distribution is that Sweden has a very low

¹⁸⁹ See Forslund & Vikström (2011) and SOU 2010:88.

¹⁹⁰ The Swedish Labour Policy Council (2017).

proportion of low-skilled jobs from an international perspective.¹⁹¹ This is estimated to contribute to the gap in employment between native-born and foreign-born individuals.

The Council therefore sees a continued need for the social partners to also be open to the idea of more regular low-skilled jobs which entail a lower cost for employers. This may entail the re-introduction of personnel categories with lower skills requirements whilst at the same time facilitating more effective use of those with a higher formal competence. More low-skilled jobs would also contribute to a more inclusive society. The crucial difference compared with subsidised employment is that this bypasses the point where the subsidy disappears and where many risk returning to unemployment. In order to ensure the net income is at an acceptable level in these jobs, they could be combined with tax breaks or transfers. The fact that this is a matter of a regular job does not necessarily mean that an individual will remain in the same job permanently. The opportunities for moving on to a more qualified job or increased income are quite good for people employed in this category.¹⁹²

BP18 includes an overview of different types of subsidised employment. Five different forms of support were compiled in one new form. The new introductory positions are intended for participants in the job and development guarantee programme and for new arrivals, and can be flexibly combined with training. The subsidy level is 80 per cent up to a ceiling of SEK 20,000 per month. At the same time, the ceilings in different subsidised employments were harmonised so that they are SEK 20,000 per month for extra services and fresh-start jobs as well.¹⁹³ Steps were also taken to simplify and reduce the administrative burden for employers in connection with subsidised employment. Table 5.2 provides an overview of the different forms of support available today.

¹⁹¹ The Swedish Labour Policy Council (2018).

¹⁹² The Swedish Labour Policy Council (2018), Chapter 8.

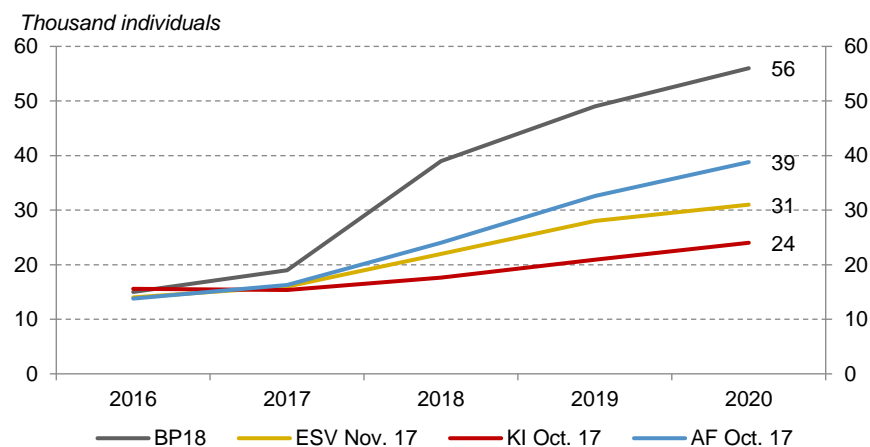
¹⁹³ A requirement regarding collective agreements was also introduced.

Table 5.2 Overview – subsidised employment

Support		Year commenced	Target group	Level and duration of subsidies	Scope (Feb. 2018)	Goal
	Modern preparatory jobs	2017	Young people in JUG, new arrivals	100%, max. 2 years	1,006	5,000 by 2020
	Extra services	2015	JUG>450 days (phase 3), new arrivals	100%, max. 2 years	12,143	20,000 by 2020
Introductory jobs	Special recruitment support		Participants in guarantees and new arrivals	80%, 2 year ceiling SEK 20,000/month	3,596	
	Enhanced special recruitment support				1,566	
	Trainee position welfare	(2016)			419	
	Trainee position shortage	(2016)			62	
	Entry jobs				2,848	
	Fresh-start jobs	2007	21–25-year-olds without full-time work for at least 6 of the past 9 months, and the long-term unemployed	1*employer contributions if unemployed <2 years 2*employer contributions if unemployed 2–3 years 2.5*employer contributions if unemployed >3 years max. 2 year, ceiling SEK 20,000/month	33,449	
	Vocational introduction positions	2014	Young, new arrivals, long-term unemployed	1*employer contributions	747	30,000

Different analysts' views of the effects of the labour market policy in autumn 2017, in terms of the number of subsidised employments, varied considerably (Figure 5.13).¹⁹⁴ The changes that the Government made to the subsidised employments in BP18 will hopefully enable more people with a weak position on the labour market to find work. There is however a risk that the Government is overly optimistic with regard to how quickly the volume can be increased in the employment measures.

Figure 5.13 Various assessments of the volume of subsidised employments



Source: BP18, The Swedish National Financial Management Authority (2017), The National Institute of Economic Research (2017a) and The Swedish Public Employment Service (2017c).

In BP18, the Government estimated that the number of individuals employed through programmes would almost triple, from 19,000 in 2017 to 56,000 in 2020. In the late autumn, ESV made a considerably more cautious estimate and forecast that the figure would double during that period; from 16,000 to 31,000.¹⁹⁵ KI was even more cautious and estimated the scope at around 24,000 people in employment measures by 2020. It is important to note in this context that the Swedish Public Employment Service, which should have the best conditions for forecasting this, has continually revised its forecast for the number of employed persons in programmes since 2016. In the estimate of expenditure from October 2017, the figure

¹⁹⁴ Formally, the fresh-start jobs are not subsidised employment: they are a right. In practice, however, they have the same function. For more information, refer to Appendix 1.

¹⁹⁵ See the Swedish National Financial Management Authority (2017).

amounted to 40,000 people by 2020; i.e. more than both KI and ESV but fewer than the Government. Overall, the Government had a considerably more positive view than the other well-informed analysts of how the volumes in subsidised employment are developing. This may, however, only partially explain the difference in the unemployment forecast.

We do not believe that we will see an increase in the number of subsidised employments this year as drastic as that forecast by the Government in the budget bill, especially considering that the majority of changes in BP18 did not take effect until March 2018. During the final months of last year, however, the extra services saw a rapid increase, employing around 12,000 people by the turn of the year.¹⁹⁶ This quick growth can be partly explained by the bonus programme which was introduced in BP18 as a means of increasing the use of the extra services. the Government allocated SEK 500 m to supporting municipalities and county council which have already employed or are currently in the process of employing persons who are far from the labour market, through the use of extra services.¹⁹⁷

There has, however, been some criticism of the choice of individuals being given these extra services, as a significant number of them have a relatively good education (table 5.3). Roughly 60 per cent have at least upper secondary education and over a quarter have post-secondary education.¹⁹⁸ A third is composed of native-born individuals with upper secondary education as a minimum, for whom job opportunities are relatively good. This indicates that the measures do not fully reach the group farthest from the labour market. If extra services are used for people who are relatively close to the labour market, the problem of displacement effects increases. There is also a risk that the extra services will then be used by municipalities as a cost-saving measure, as it is in practice a matter of free labour with relatively good qualifications. At the same time, a subsidised

¹⁹⁶ In March 2018, the number has increased further, now totalling 14,000 people. A total of over 23,000 people were in subsidised employment (fresh-start jobs not included).

¹⁹⁷ BP18, Expenditure area 14, p. 39. In accordance with the bonus system, every municipality and county council are assigned a target number of extra services based on the number of inhabitants. If a municipality or a county council reaches their target, they receive a state subsidy corresponding to SEK 71,000 per extra service. If the number is lower, the state subsidy is reduced in proportion to how much it falls short of the target. The remaining funds are then distributed among the municipalities/county councils that exceed their targets). See DECLARATION OF INTENT between the Government, the Swedish Trade Union Confederation (LO), Unionen and the Confederation of Swedish Enterprise, 5 March 2018, www.regeringen.se.

¹⁹⁸ This distribution is based on (2018a).

employment can act as an important stepping stone for people who lack experience of and a network on the Swedish labour market to find a regular job – new arrivals, for example. This means that such positions may also be important for some people with better qualifications. The stepping stone effect also seems to be of great importance for individuals born outside of Europe.¹⁹⁹

Table 5.3 Distribution of extra services by level of education and origin in per cent

Level of education	Country of birth			Total
	Outside of Europe	Within Europe, outside of Sweden	Sweden	
Primary/lower secondary	2.3	7.5	30.4	40.3
Upper secondary	2.8	16.1	14.6	33.5
Post-secondary	1.7	4.8	19.7	26.2
Total	6.8	28.4	64.7	100

Source: Arbetsförmedlingen (2018a).

In-depth analysis 5.2 Introductory jobs: an initiative of the social partners

In addition to the Government's active labour market policy, the social partners also play a central role. In autumn 2017, unions and employers came to an agreement with the aim of enabling new arrivals and the long-term unemployed to more easily find jobs; these were known as "etableringsjobb"; introductory jobs.²⁰⁰ On 5 March this year, the Government and the social partners presented a declaration of intent which entailed that the introductory jobs may come into play in the second half of 2019.²⁰¹ The Government shall submit a proposal to the Riksdag in the Spring Fiscal Policy Bill of 2019.²⁰² The introductory jobs are temporary positions with a trial period of two years which are normally intended to continue into regular permanent employment thereafter. The work is combined

¹⁹⁹ See the Swedish Labour party Council (2018), Chapter 3.

²⁰⁰ Included in the agreement are the Swedish Trade Union Confederation, Unionen and the Confederation of Swedish Enterprise.

²⁰¹ DECLARATION OF INTENT between the Government, the Swedish Trade Union Confederation (LO), Unionen and the Confederation of Swedish Enterprise, 5 March 2018, www.regeringen.se.

²⁰² One reason why the proposal cannot be made earlier is that the Government feels that the EU needs to be notified.

with education (primarily SFI, but also other courses within the regular education system).

The introductory jobs differ from existing forms of subsidisation. The biggest difference is that the subsidy goes directly to the individual, rather than the employer being compensated by the state afterwards, as is the case with other subsidies. The administrative burden for the employer is thus reduced. In accordance with the agreement, the employer must employ the individual at a cost (including employer contributions) of SEK 8,400 per month, providing the employee with a net wage of SEK 5,700 per month. On top of this, state compensation of SEK 9,870 per month is paid directly to the individual, giving a total disposable income of SEK 15,600 per month. This corresponds to a subsidy level of 54 per cent, which is somewhat higher than for fresh-start jobs, for example. At the same time, this form of employment is easier for employers to administer and therefore has the potential to reach a higher volume. The goal is for the number of introductory jobs to reach 10,000 in the long term.

The Council feels that it is not clear in what way the new introductory jobs would work considerably better than existing subsidised employments. It is positive, however, that this is a structure which has come about on the initiative of the social partners and which should therefore be better adapted for them and perceived as less complex. If the introductory jobs are a success, it is still probable that a great deal will be achieved through overflows from existing subsidies. It is therefore uncertain as to whether the total volume in the measures will increase to a significant extent.

Subsidised employment is however only one part of the active market policy. Other initiatives such as increased investments in the validation of education, fast-tracking, etc. also have a significant impact on the workings of the labour market. In all probability, the introduction of compulsory training/education in the establishment programme will also improve job prospects among new arrivals in the long term.

Another part of BP18 which affects the labour market primarily in the long term is an additional expansion of the Adult Education Initiative; an investment which the Government initiated upon coming into power in 2014. Fully implemented, the Adult Education

Initiative shall, according to BP18, entail 93,000 new study places in Yrkesvux and Komvux, as well as universities and other higher education institutions, by 2021.²⁰³ If more people choose to study and leave the labour force for this reason, however, unemployment may also be lower in the near future. As previously mentioned, it is above all the assessment of the development of the labour force in 2018 which has led to the difference in the assessment of unemployment compared with KI in BP18. One interpretation of the Government's forecast is that the Government's assessment is that fewer people are participating in the labour force because they are studying.²⁰⁴ This is not commented on in BP18, however.

5.2.3 What is required for the forecast to be realised? – a sample calculation

In BP18, the labour force is estimated to rise by approx. 85,000 people and employment by just under 113,000 by 2020. The number of unemployed is thus estimated to decrease by just under 28,000 people.

In order to illustrate what is required in order for the Government's forecast for 2018 to be realised, we will use a sample calculation.²⁰⁵ For the coming years, it is estimated that the foreign-born segment of the population will grow, whilst the native-born population will decrease.²⁰⁶ From a historical perspective, there is currently an unusually high number of people staying in Sweden for shorter periods of time. As it takes time to become established on the labour market, it is assessed that this will affect the development for a number of years. The employment rate among new arrivals is for

²⁰³ In VP18, the number of places was further increased to 100,000 by 2021. See VP18 p. 28.

²⁰⁴ Whether an individual is included in the labour force is not, however, determined by whether or not they are studying; rather, the individual indicates in AKU that they are looking for or are willing to take on a job.

²⁰⁵ The example is based on the data available when the bill was made, i.e. AKU up to and including the second quarter of 2017 and SCB's population projection from 2017.

²⁰⁶ Based on SCB's population projection, the foreign-born population is estimated to grow by around 170,000 people by 2020, 140,000 of which are born outside of Europe. At the same time, the native-born population is estimated to decrease by 45,000 people. In BP18, the Government has also taken into consideration the Swedish Migration Agency's forecasts after the population projection, in which it estimates the population increase to be somewhat lower; totalling 112,000 people. In the sample calculation, we allow for development of the population segments as per SCB's project and apply these figures to the Government's total.

example over 30 per cent after four years, and is rising gradually.²⁰⁷ Over a period of some years, new arrivals' entry to the labour market is therefore expected to provide a cushioning effect on the employment rate. At the same time, labour force participation is relatively high among new arrivals, which is likely attributable to the fact that various compensation systems, such as establishment compensation, are linked to being at the labour market's disposal.

With an assumed 60 per cent labour force participation and 30 per cent employment rate among new arrivals, and an unchanged level of participation among other foreign-born individuals, the estimated increase in the foreign-born population corresponds to an additional 104,000 people in the labour force.²⁰⁸ We also work from the assumption that labour force participation among the native-born population will rise somewhat and partly compensate from the group's reduction in size. At the same time, we also make the assumption that unemployment among native-born individuals will decrease by 0.5 percentage points.

In order for the Government's forecast to be realised, it would be necessary, based on these assumptions, for the employment rate among foreign-born individuals to rise by 1 percentage point (which means an increase of 4 percentage points among those who are not new arrivals in order to compensate for the lower employment rate among individuals who have only been in the country for a short time). This would constitute a very big change and we do not feel it is likely that this will happen with a target year as soon as 2020. If unemployment among native-born individuals falls by 1 percentage point instead, the employment rate among foreign-born individuals – including the additions to the population by 2020 – must at least remain unchanged.

5.2.4 View of equilibrium unemployment

In a somewhat longer perspective, the view of equilibrium unemployment also affects assessment of how actual unemployment

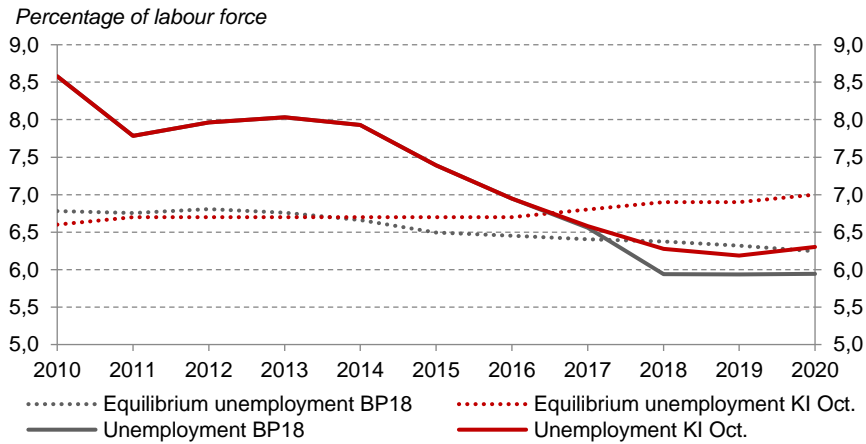
²⁰⁷ The figure relates to the age group 20–64 and is taken from the Swedish National Financial Management Authority (2017b) p. 28.

²⁰⁸ The increase in the population is divided by origin, where individuals born outside of Europe are assumed to be primarily asylum seekers (new arrivals). Among other foreign-born individuals, there is also a higher proportion of labour migrants, and the employment rate is higher. For this group, labour force participation is deemed to be the same as in the foreign-born population on average.

will develop. The differences in the Government and KI's picture of unemployment are also reflected in the view of how large a proportion of it is structurally dependent (Figure 5.14).²⁰⁹ In autumn 2017, KI's estimation of equilibrium unemployment for 2018 was half a percentage point higher than that of the Government and the assessment was that this would increase somewhat, reaching 7 per cent by 2020.²¹⁰ the Government's assessment is instead that equilibrium unemployment will decrease somewhat in the coming years. The difference will thereby increase, amounting to 0.8 percentage points by 2020.

However, the difference between actual unemployment and equilibrium unemployment – the “unemployment gap” – does not differ as much between the Government and KI, as KI forecasts both higher actual unemployment and higher equilibrium unemployment. The difference is 0.2 percentage points in 2018 and will increase to 0.4 percentage points by 2020.

Figure 5.14 the Government and KI's view of unemployment and equilibrium unemployment



Source: BP18 and NIER (2017a).

The forecasts for unemployment and equilibrium unemployment are key to the assessment of net lending in that they affect expenditure (unemployment benefits) and revenues (more employed people

²⁰⁹ See Fiscal Policy Council (2017) for a review of the Government and KI's methods of estimating equilibrium unemployment.

²¹⁰ See NIER (2017b).

means higher tax revenues). Equilibrium unemployment is also an important premise for estimating potential GDP.²¹¹ Given the assessment of potential labour, a lower assessment of equilibrium unemployment means a greater employment potential and therefore higher potential GDP. As put forward in Chapter 2, there are relatively large differences between how KI and the Government view structural net lending in the coming years, for example. We estimate that much of the difference in the autumn forecasts is attributable to different assessments of equilibrium unemployment. In light of the fact that equilibrium unemployment plays a key role in the assessment of potential GDP, as well as structural net lending in the long term, the Council called for sensitivity analyses of various assumptions about equilibrium unemployment in last year's report. In VP18, the Government provided these calculations, with the assessment that an assumption of higher equilibrium unemployment would not jeopardise fulfilment of the surplus target. The results are consistent with the Council's rough calculations in this report (see Chapter 2).

5.2.5 Spring 2018

During the winter, the Government revised its unemployment forecast. In VP18, the forecast was subject to further upward adjustment, primarily with reference to the fact that the labour force has undergone a more drastic development than expected. The rate of employment is also estimated to have increased.²¹² Unemployment is now estimated at 6.2 per cent in 2018 and it is expected to decrease marginally by 2020. At the same time, we can establish that other assessors revised their unemployment forecasts somewhat in the opposite direction. The view of growth in employment and labour in the coming years now differs only very slightly between the Government and KI. Overall, this means that the major differences in the views of unemployment which prevailed in the autumn have now been replaced by much greater consensus (table 5.4).²¹³

²¹¹ the Government's memo "Metod för beräkning av potentiella variabler april 2018" [method for calculating potential variables, April 2018] provides a brief description of the method used by the Ministry of Finance to calculate potential GDP.

²¹² Compared with BP18, the growth in the labour force was revised up by 0.4 percentage points to 1.0 per cent and employment growth by half as much, to 1.4 per cent, in 2018.

²¹³ The scope of subsidised employment is now also similar to KI's assessment.

Table 5.4 Unemployment forecasts, spring 2018

	VP18	NIER	RB	ESV
2017	6.7	6.7	6.7	6.7
2018	6.2	6.3	6.3	6.4
2019	6.2	6.2	6.4	6.3
2020	6.1	6.2	6.4	6.3

Note: Per cent of the labour force, 15–74 years old.

Source: VP18, NIER (2018a), Sveriges Riksbank (2018) and the Swedish National Financial Management Authority (2018).

At the same time, we can establish that the differences in the view of equilibrium unemployment between the Government and KI remain, and that they also contribute to different assessments of the structural net lending in the spring forecasts.

In recent years, the labour force and the employment rate have grown, primarily among foreign-born individuals.²¹⁴ Since summer 2017, however, the outlook has been different. Though the number of employed individuals has continued to rise, this has primarily taken place among the native-born population. The employment rate and labour force participation among foreign-born individuals has in fact decreased, and unemployment in this group has remained unchanged. It is too early to determine whether the weak development of recent times among the foreign-born population is a break in the trend, but the development may indicate that the Government's assessment of equilibrium unemployment is overly optimistic.

5.3 Assessments and recommendations

Overall, the Council's assessment is that the majority of measures in the labour market area in BP18 are appropriate. However, the council believes that extensive work remains to lower labour market thresholds, improve matching and reduce the discrepancies between native-born and foreign-born individuals. KI's assessment was that the impact of the labour market policy in BP18 on equilibrium unemployment was minor.²¹⁵ The council shares this view.

²¹⁴ Between the first quarter of 2014 and the second quarter of 2017, the labour force grew by some 220,000 people, only 10,000 of which were native-born. Employment grew during the same period by 280,000 people, less than a third of which were native-born.

²¹⁵ NIER (2017a).

the Government's goal for Sweden to have the lowest rate of unemployment in the EU is a guiding principles for the fiscal policy. We still believe that the goals for the labour market should be linked to the problems which exist on the domestic labour market so that they can be evaluated based on the Swedish development and policies.

The unemployment forecast for 2018 in BP18 deviated from that of other assessors. The council believes that the forecast was overly optimistic. Rough calculations indicate, for example, that the rate of employment among foreign-born individuals would need to rise very quickly in order for the Government's forecast to be realised. We do not consider this likely in the short time.

There are strong indications of lasting matching problems on the Swedish labour market, which entails a certain upward pressure on equilibrium unemployment. In addition, the majority of those coming to Sweden during the period 2015-2016 are now starting to find their way out into the labour market. The board believes that the Government's assessment of equilibrium unemployment risks being overly optimistic.

The Adult Education Initiative is a broad investment within several different segments of the education system which in the long term can serve both to strengthen job opportunities for those with a weak connection to the labour market and to remedy the prevailing shortage on the labour market. The council calls for a comprehensive follow-up of the measures within the Initiative.

Even if major investments are made in education, there will be individuals with very low qualifications who, despite extensive education initiatives, will not find regular employment, and for whom limited, subsidised employment is insufficient in order to become firmly established on the labour market. The Council therefore sees a continued need for the social partners to also be open to the idea of regular low-skilled jobs.

6 Capital taxes

The council has discussed various capital taxes in previous reports. In the 2008 report, the Council was critical of the recently decided property tax reduction effectuated in the form of the transition from property tax to property fee. The council found it “difficult to find any socioeconomic argument for the change to the property tax which has been implemented.” In the 2016 report, the Council showed that a return to a property tax which is in proportion to the property’s value would have a favourable distribution profile and – if the tax was 30 per cent higher than the property fee – would constitute a relatively small part of disposable income. In the latter report, as with the reports of previous years, we find that problems linked to households’ indebtedness and high housing prices should be addressed with a combination of increased property taxation and limited right to interest reduction.

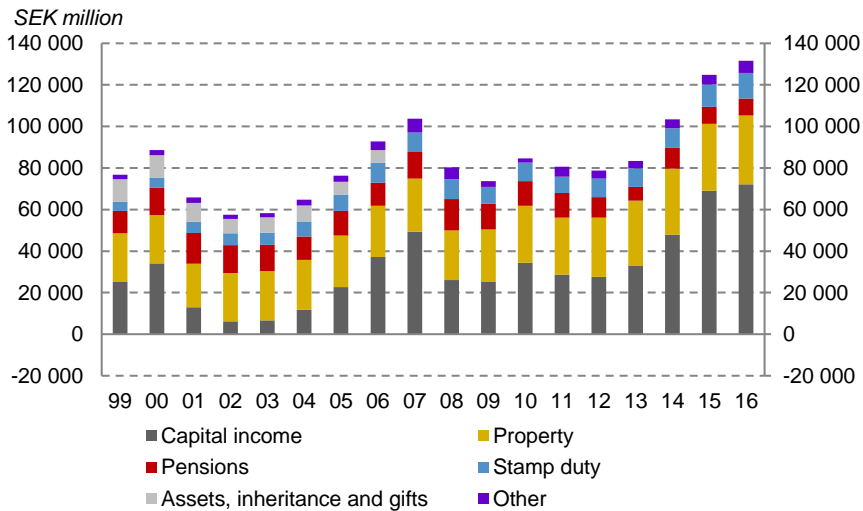
When property tax was done away with in 2008, capital gains tax from property sales was also tightened. At the same time, deferred tax became subject to interest. The effect was an extra cost associated with changing property. In the debate, it is sometimes referred to as a “relocation tax” which is considered to have a highly negative impact on mobility. In the 2017 report, we discussed the regulation of rent setting, which has negative effects on mobility on the rental market, among other things. In this section, we look closer at how great an impact capital gains tax on property sales has on relocation costs and mobility on the owner market.

We are also studying another tax reform which affects transaction costs and mobility; namely, the introduction of investment savings accounts (ISK) in 2012. No special capital gains tax is paid on assets in ISKs; only a standard tax related to the value of the asset is paid, meaning there are no extra costs in conjunction with a sale. The transition from normal income tax on realised capital gains to ISK has therefore had a positive effect on the incentive to sell, contrary to the 2008 property tax reform. We also discuss if ISKs can be seen as favourable in terms of taxation in relation to conventional income taxation of financial assets.

6.1 Background

Between 10 and 15 per cent of households' factor income is constituted by returns on different forms of capital.²¹⁶ This includes income from various financial assets such as bank savings, funds and shares such as capital gains on properties. Revenues from various taxes on households' investment income amounted to 132 billion in 2016, corresponding to 7 per cent of total tax revenues. Direct taxes on investment income correspond for over half of these, 72 billion, whilst the remainder consists primarily of taxes on property (property tax and stamp duty). Taxes on assets, inheritance and gifts, which were abolished in 2007, only accounted for a small proportion of tax revenues. The development of the various types of tax over time is depicted in Figure 6.1.

Figure 6.1 Revenues from households' capital taxes 1999-2016



Source: Swedish Tax Agency's website.

Table 6.1 shows the composition of the taxable investment incomes. The largest individual item is capital gains on property (net after losses) which in 2016 corresponded to more than half of households' combined investment income. The second largest item is interest and

²¹⁶ According to SCB's statistics on household finances (Hushållens Ekonomi; HEK), the average was 12.2 per cent for the period 1995–2013.

dividends, but the net after interest on debts corresponds to less than a fifth of the total amount.

Table 6.1 Households' taxable investment income, 2016

Income type	SEK billions
Interest and dividends	117.4
Investment Savings Account	7.6
Penalty interest, capital gains	4.7
Capital gains on property, net	142.3
Other capital gains, net	34.8
Interest expenses	-76
Other	9.7
Total	240.6

Source: Swedish Tax Agency.

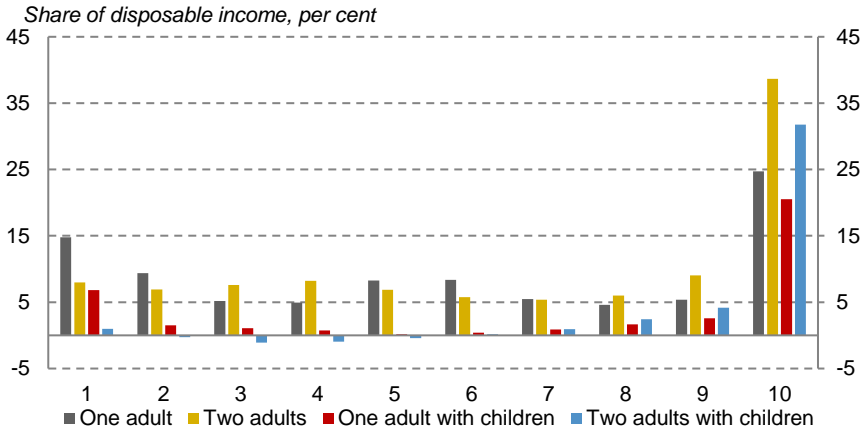
Investment income is more unevenly distributed than income from employment. In 2015, the Gini coefficient of the total disposable income of households was 0.32 including all forms of income, but only 0.24 if the investment income is excluded. This difference has increased in later years while the income difference has grown. In the early 1990s, the Gini coefficient of the households' disposable incomes was somewhat higher than 0.2 while the exclusion of the investment incomes only reduced the coefficient by a few percentage points.²¹⁷ One way to illustrate how the investment incomes are distributed is to rank the households by their disposable income. In Figure 6.2, the households have been divided into four categories according to the household's composition.²¹⁸ In each category, the households have then been ranked by their disposable income and divided into ten equally large groups: decile groups. The height of the bars indicate the taxable investment incomes' share of the disposable incomes. As you can see, the share is significantly higher in the highest decile group, while the differences between the other deciles are relatively small. For families with children, the investment incomes are essentially zero except in the highest decile group.²¹⁹ The investment incomes' significance to the income distribution is discussed further in Chapter 7.

²¹⁷ Waldenström et. al. (2018), Figure 3.4.

²¹⁸ This and the following figure of distributional data are based on calculations with SCB's FASTT model.

²¹⁹ In investment incomes, the dividend yield of owned residential properties are not included, only capital gains from sales.

Figure 6.2 Tax capital surplus 2016, divided by income deciles



Note: The households are ranked by equivalised disposable income excluding capital gains, while the denominator and the numerator of the quota between capital surplus and disposable income include capital gains.

Source: Statistics Sweden.

From a distribution policy point of view, it can therefore be natural to tax capital gains higher than other incomes. Simultaneously, one should consider that taxation on capital gains influence the incentives for savings and capital formation with potential long-term effects for production and growth. This may support a relatively low taxation on capital; there are even theoretical arguments that investment incomes under strongly stylised conditions (e.g. infinite horizon) should not be taxed at all. In practice, it is also difficult to draw a sharp line against incomes from employment since these are partly the result of investments in education (human capital). Therefore, most tax systems seek to find a happy medium between low capital tax, which could be motivated by efficiency reasons, and a high tax, which could be beneficial in terms of distribution policy.²²⁰

After the tax reform that was decided in 1991 and applied 1992, the nominal tax rate on the households' investment incomes is 30 per cent. This is indeed on the lower edge of the typical marginal tax on incomes from employment, but in relation to the real investment income, the tax rate is higher than 30 per cent. For example, in the case of a 2 per cent inflation and a 3 per cent real return, 30 per cent

²²⁰ See, for example, Waldenström et al. (2018), Chapter 2, for a relevant overview of the academic literature on capital taxation.

of the nominal income (5 per cent) equals 50 per cent of the real income.

The structure of the capital taxes are as significant as their general level. The fact that tax revenues on investment incomes are as low as 7 per cent of the collective tax revenues is because not all kinds of investment income are taxed in full, while lending rates are fully deductible. Therefore, the taxable return on real estate, unit trusts and financial assets are calculated at ISK according to standards that tend to underestimate the actual return. Furthermore, capital gains from residential properties are taxed at a reduced rate, and the tax is not levied until the return is realised, which means a lower effective tax rate than running taxation on change in value. As the Council has noted in earlier reports, this lack of uniformity is problematic.²²¹ Since the return on small houses and tenant-owner's rights is low, investments in residential properties is favourable in comparison to investments in other sectors. Since interests are fully deductible while many kinds of investment incomes are taxed at a low rate, the households' indebtedness is stimulated.

The lack of uniformity is largely the result of tax changes in the 2000s. The tax reform of 1991 was aimed towards a uniform taxation on all kinds of investment income. However, later reforms have lowered the tax on certain forms of investment income and thereby moved away from uniformity. The tax on properties has been lowered in several steps. When the former property tax was replaced by a property fee in 2007, it amounted to a significant tax relief. Simultaneously, a certain tightening of taxation on capital gains was made by increasing tax rates from 20 to 22 per cent and by introducing a standard interest rate on transitional reserves from earlier gains. Another tax reform is the introduction of the investment savings account for financial assets in 2012. The reform means that the return on shares and other financial assets are taxed according to relatively low standard amounts.

The problem with the residential property taxation is not only the low general level, but also that a significant part of the tax is charged on capital gains. Since this tax is not levied until the gain is realised, it risks generating lock-in effects and decreasing mobility on the residential property market.

²²¹ Fiscal Policy Council (2008, 2011 and 2016).

6.2 Departure from uniformity

In theory, it is simple to design a uniform investment income tax: all investment incomes are taxed equally from where they stem – bank savings, shares, real estate or other real and financial assets – and regardless in what form they are paid out – interest, dividends, capital gains or the value of different incomes in kind that the asset generates.²²² In other words, consistent uniformity means that the year's value change along with the value of benefits in kind shall be added to interests and dividends.

Even if the aim is uniformity, such an ideal is difficult to realise for several reasons. A basic problem is that investment incomes often are impossible to observe and measure with satisfactory precision. Firstly, change in value can be difficult to measure before the asset in question has been divested. This especially applies to unique assets such as real estate, but also financial assets that are not bought and sold on a ready market with running quotations. For this reason, capital gains are generally not taxed until they are realised. Second, benefits in kind are difficult to estimate. One who owns their own residence enjoys “residential services” the value of which corresponds to the rent of an equivalent residence. The owner pays rent to themselves, so to speak. But since real estate constitutes a unique object, this rent cannot be observed but must be estimated. Since rise in value and benefits in kind do not generate running revenues, it can also create liquidity problems for the households if these incomes are taxed continuously.

Therefore, all tax systems depart somewhat from uniformity in practice. Firstly, capital gains are normally not taxed until they are realised. Since taxation is postponed until the moment of realisation, the gain can be measured with precision, and the tax payer can use a part of their potential profit to pay the tax. Second, different standards apply, e.g. that the tax is based on the asset's value. Such standards can register both the value of benefits in kind and normally running rise in value. In the Swedish tax system today, there are two significant examples of such standard taxation: the property fee and the taxation of ISK. However, in neither case can these taxes be argued as ways to tax rise in value and/or benefits in kind. For

²²² We disregard the double taxation that arises when returns on corporate investments are taxed both through corporation tax and through tax on the households' dividends and capital gains of shares.

financial assets placed in ISK, there are no benefits in kind to tax, and the problems to measure rise in value are generally small. For small houses, the property fee does not correspond in any reasonable way to the value of the residential services, since it is completely independent of the size and value of houses above the threshold, i.e. half of all small houses.

Even considering the different practical problems, it would be fully possible to get closer to the ideal of uniformity simply by returning to the tax system of 1992. For financial assets, a running taxation of dividends and interests applied then, and capital gains were taxed at the moment of realisation. For real estate applied partly a property tax with a fixed share of the assessed value – a reasonable measurement of the value of the residential services – and partly a tax on realised capital gains.

A problem with taxing capital gains first when they are realised is that the tax can be perceived as a taxation on the sale itself, since it can be avoided by refraining from selling. In that case, the tax can have lock-in effects: households tend to keep their residential property and their financial assets longer due to the tax. For shares, the tax makes it difficult to choose an efficient portfolio and decreases the liquidity of the market. For residential property, the mobility is decreased, and the number of residences is used less efficiently. The capital gains tax on residential properties is therefore sometimes spoken of as a “moving tax”.

However, it is slightly misleading to characterise the capital gains tax as a transaction tax or moving tax. Normally, assets must be sold sooner or later, and therefore, it is a matter of choosing when to pay the tax rather than completely avoiding it. It is certainly possible to speculate about the possibility of the tax rate at the time of a future sale being lower than today, but it may also be higher. If we disregard such speculation, the owner's gain by postponing the time of sale amounts only to an interest gain. As long as the asset is not sold, the case can be considered as the state giving an interest-free respite on paying the tax on the running rise in value. The net present value of the tax is thus lower if the whole taxation is paid at one distant, future point in time than if it were paid continuously at every year's rise in value. The more often a household moves, the greater this interest loss becomes. In that sense, the capital gains tax generates

lock-in effects. It is the interest loss that really constitutes a “moving tax”, not the capital gains tax itself.

In practice, it is difficult to fully reach a running tax on each year’s unrealised rise in value. Not least of all, a running tax could create liquidity problems. If we still wish to remove or diminish the risk of lock-in effects, there are different ways to do so. One way is to, like today, extract tax at the time of sale but adapt the nominal tax rate so that it considers the interest effect; the tax rate would thus increase with the holding time. Another way is to pay capital gains tax in connection with a sale. If the deferment is interest free, as in Sweden up until 2007, the interest gain is eliminated by postponing a sale. In contrast, if interest is imposed on the deferment, such a gain remains.

It is worth noting that both reforms of taxation on residential properties and financial assets that have been adopted have had the opposite effect on the incentives to mobility. On residential properties, the tax rate on capital gain has increased while interest on the transitional reserve has been introduced. Hence, mobility has been punished. On financial assets in ISK, however, the connection to realised gains has been completely removed. Hence, mobility has been stimulated. A wish to stimulate share trading was also put forward as one of the motives behind introducing ISK.

6.3 Taxation on wealth or investment income?

Tax on capital can be levied on the income that the capital generates or on the wealth itself. Up until 2007, when the wealth tax was abolished, Sweden had a tax on investment income as well as wealth. In practice, the distinction between the two kinds of tax is fluid. The income tax system of today actually contains significant elements where the tax is in direct correlation with the wealth value (ISK, real estate fee). With a wealth based tax, another definition of uniformity becomes natural: namely, that a rearrangement of the wealth – e.g. a loan financed investment or an exchange of two assets – should not influence the size of the tax. A box model for taxation can be used

for this purpose.²²³ Such a model is applied in the Netherlands since the early 2000s.²²⁴

A symmetrical investment income tax and a symmetrical box tax have different impacts since most investments are risky. A wealth based tax could be said to hit the average or expected return *ex ante*, while the regular investment income tax is imposed on the realised return *ex post*. Since stock prices, like real estate prices, vary randomly time and again, there is a significant difference between these two taxes. With a box tax, one who by luck or skill has received an unusually high return will not be taxed on the part of the return that exceeds expectation. In reverse, the person will also be target for loss in relation to expected return. With a uniform income tax, the state is a participant and shares the excess returns and the negative returns.

In so far as differences in return between different individuals correlates to skill, the wealth tax gives incentive to seek profitable investments. If the tax instead is based on the realised return, such incentives grow weaker, since a part of the excess return falls away in taxation. In so far as differences in return depend on chance, which should mainly concern liquid financial investments, a standard tax results in the individual tax payer carrying all the risk. With a regular income tax that is based on the actual return, the state steps in and shares the risk.

Hence, there are valid arguments for both kinds of uniformity. A uniform tax based on actual income follows X and can be used as a tool for redistribution.²²⁵ It also results in the state taking on a part of the individuals' risk. A wealth based tax can be easier to administrate, both for the tax agency and for the individual. It also eliminates the lock-in effects that comes with an income based tax.

The Swedish tax system mixes up these principles in a seemingly inconsistent way. For one group of assets – bank saving, shares and other financial assets besides ISK – the actual return is taxed. For another group – financial assets on ISK – a part of the market value is taxed. For a third group – real estate and investment funds – a running, value-related tax is combined with a tax on actual capital gain when they are realised.

²²³ The title refers to the assets being put into a “box” where the tax is based on the net value of the assets in “the box”. Lodin and Englund (2017) discuss how such a tax could be designed in Sweden.

²²⁴ See, for example, Cnossen and Bovenberg (2001).

²²⁵ See Waldenström et. al. (2018) for a discussion.

6.4 Capital gains tax and lock-in effects on the residential property market

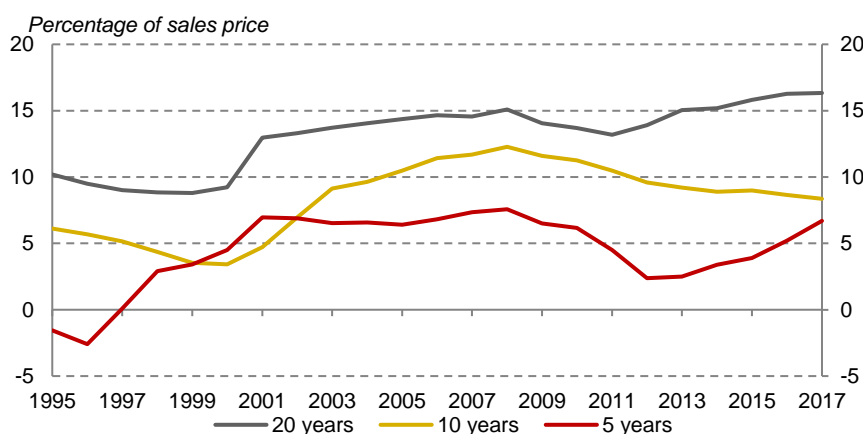
The problems with lack of mobility are especially serious on the residential property market. Obstacles for mobility results in the inefficient use of the number of residences, while the job market functions worse. In the 2017 report, the Council discussed the market for rental apartments and found that the rents in attractive locations today are way below market level. This tends to create lock-in effects, since the one who wishes to move gives up their favourable rent at the same time as it is difficult to find attractive alternatives on the rental market. Similarly, a lack of mobility on the owner's market can create problems by limiting the supply of certain kinds of residences. Therefore, it is important to assess to what extent the tax system decreases mobility on the owner's market.

Lock-in effects arise because capital gains are not taxed until a residential property is sold and a gain (or loss) is realised. Considering the quick price rise of real estate in recent years, a significant part of the revenues tends to fall away on sale. The tax burden is caused by the historical price development during the holding time, and for a residential property purchased long ago, it could be a matter of large amounts. This is illustrated in Figure 6.3 which shows the development of the capital gains tax for an average small house purchased 5, 10 and 20 years ago, respectively. For a house purchased 20 years earlier, the tax has amounted to 10-15 per cent of the sales price with a vaguely rising trend over time. For shorter holding times, the tax has been lower with greater variations from year to year. The tax was raised significantly for all holding periods in 2001 when the nominal tax rate was increased from 15 to 20 per cent, while the 2008 increase from 20 to 22 per cent was too small to be seen in the figure.

The tax illustrated in Figure 6.3 is sometimes referred to as "moving tax". It probably feels that way to many tax payers. It is easy to forget that, sooner or later, the time will always come to move, even if it essentially can be delayed for generations. The extra cost that comes with a move is therefore not equal in sum to the entire capital gains tax, but consists only of the extra tax expense of moving earlier versus moving later, i.e. the interest expense of bringing a move forward. This cost naturally depends on how imminent a

future move is. The size of “the move tax” therefore varies from case to case due to individual circumstances. A household will only move if the advantages of changing residencies are greater than all the moving costs. The advantage can both take the shape of a residence that is in a better location and is better adapted to the needs of the household and of money made available for other consumption. The greater the extra tax expense, the more people refrain from moving, and the property market becomes less mobile.

Figure 6.3 Capital gains tax 1995–2017, 5, 10 respectively 20 years holding period



Note: The tax is calculated as $a(P_t - P_{t-x})/P_t$, where a is the tax rate on capital gains (15 per cent prior to 2000, 20 per cent in 2001–2007 and 22 per cent in 2008), P_t is the property price index for small houses (SCB) and x is 5, 10 respectively 20 years.

Source: SCB and own calculations.

The state can counteract the lock-in effects by giving a deferment on paying tax on a realised capital gain until a later date. Such a deferment was previously allowed for the portion of the purchase sum that was reinvested in a new residential property. The possibility of deferment was removed in connection with the tax reform of 1991, but was reintroduced as early as 1993. Up until 2007, the deferment was interest free, which completely eliminated the lock-in effect. Without interest on the deferment, the tax on the historical capital gain is not affected – up to a point – by whether a residential property is sold or not. However, when the property tax was removed in 2008, interest was imposed on the transitional reserve, and since then, an annual standard interest is taken of 1.67 per cent

of the deferment up to a taxation of 30 per cent. After tax, the deferment interest amounts to 0.5 per cent of the capital gain each year. With the loan interests of today, however, deferment is not particularly beneficial. In many cases, an alternative to deferment is to take out a bank loan to pay the tax immediately at the moment of sale. With a 30 per cent interest deduction and a tax rate of 22 per cent for capital gains, the interest expense for such a loan is lower than the standard interest on the deferment if the bank interest is below 3.25 per cent.²²⁶ Since 2008, the mortgage rates have only been higher than that in the period January 2011 to October 2012.²²⁷

It is not surprising then that the majority of households today pay their capital gains tax right after a sale, hence not making use of the possibility of deferment. Of a total gain from sales of small houses and tenant-owner's rights amounting to SEK 159 billion in 2016, deferments were given for gains amounting to BNSEK 29. In previous years, before the deferment was imposed with interest, they would have risen quickly. The total transitional reserve from small house sales increased from SEK 128 billion in 2004 to SEK 233 billion in 2008. Subsequently, the increase tapered off, and in 2016, the deferments amounted to SEK 283 billion.²²⁸

How may one estimate "the moving tax"? The answer to that question varies from individual to individual depending on the relevant comparable option. An illustrative example that comes up in debate is a middle-aged household that "outgrew" their current residence when the children moved out, and is considering changing to a smaller, but perhaps more centrally located, residence. To get a sense of the extra moving cost for such a household, a comparison of two alternatives can be made: to sell the current residence and purchase another, equally expensive, residence or to keep the current residence "for life", up until a future division of an inheritance or a move to a care facility. The saving of staying ("the moving tax") then depends on four factors; the tax rate, how much the house has increased in value since its purchase, when it is to be sold in the

²²⁶ The deferment interest of 0.5 per cent of the gain is to be compared to an interest expense after tax of 70 per cent of the loan interest multiplied by 22 per cent of the gain. This interest expense is lower than the deferment interest if the loan interest is lower than $0.005 / (0.7 * 0.22) = 3.25$ per cent.

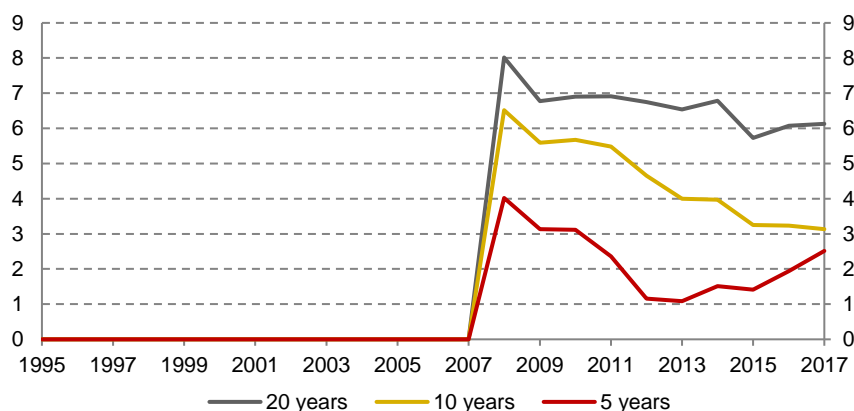
²²⁷ One-year mortgage rates according to SEB.

²²⁸ Swedish Tax Agency.

future and the discount rate²²⁹. The first two factors determine the capital gains tax illustrated in Figure 6.3. To calculate “the moving tax” in our example, we also assume that the house will be sold in 20 years and that the discount rate applies to a ten-year mortgage rate after tax.²³⁰ “The moving tax” may then be calculated as the difference in present value of tax payments between the two alternatives, expressed as a part of the current house price. The result of this calculation is illustrated in Figure 6.4.

Figure 6.4 “Moving tax” at different holding periods 1995–2017

Percentage of sales price



Note: The numbers refer to the capital gains tax from Figure 3 multiplied with a discounting factor of $1 - 1/(1+r)^{20}$, where r is a ten-year mortgage rate after tax.

Source: SCB and own calculations.

As long as the deferment was not imposed with interest, to postpone tax payment was always advantageous, and the “moving tax” remained at zero. Then, in 2008, when deferments were imposed with interest, “the moving tax” – with its given circumstances – landed somewhere between 4 and 8 per cent of the sale price depending on the holding time. It has dropped somewhat since, foremost due to lower interest rates, and lies today between 2.5 and 7 per cent. Thus, the calculated moving tax corresponds to less than half of the capital gains tax in Figure 6.3. For longer holding periods, longer time before eventual sale and on markets with a stronger historical price development, it will of course be higher. Also relevant

²²⁹ The calculation presumes that the tax is not paid in advance. A rational calculation depends on whether the owner's discount rate is higher or lower than the deferment standard.

²³⁰ The mortgage rate in use is taken from SEB's website.

discount rates may differ between households. Access to saved funds may motivate a lower discount rate and thereby a lower extra moving cost. At the same time, many households obviously choose deferment on their tax, perhaps because they have neither the possibility to loan nor assets that are easily sold. In such cases, the moving tax may be calculated as the sum of all deferment interests discounted with a higher discount rate (see Appendix 2).

However the moving tax is calculated, it is far from negligible. For example, it may be compared to another tax related moving cost, namely the stamp duty for property which amounts to 1.5 per cent of the purchase sum. In comparison, the capital gains tax consequently gives rise to a moving cost that may be twice as large during normal holding times.

How big may one expect the lock-in effects of the capital gains tax to be? The development of the number of pre-sold residential properties in Figure 6.5 gives a rough indication.

Figure 6.5 Quota of pre-sold small houses and tenant-owner's rights 1990–2016



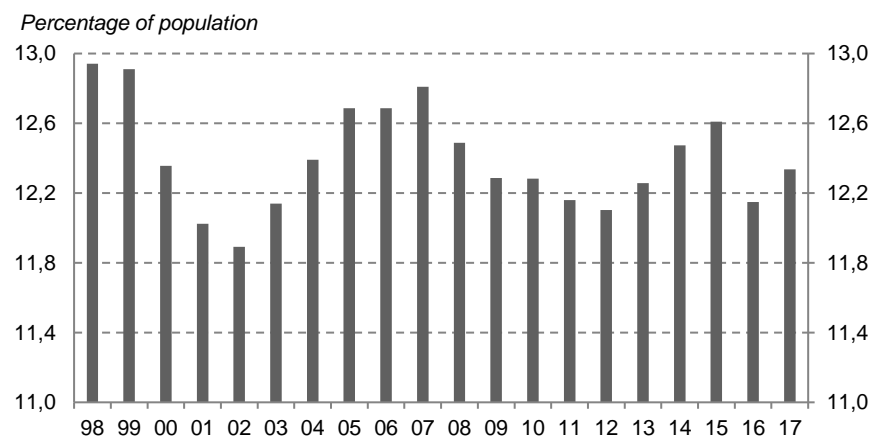
Source: Statistics Sweden.

The turnover of small houses is low – the sales quota has fluctuated between 2 and 3.5 per cent of the total number – while it is higher for tenant-owner's rights as approximately every tenth tenant-owner's right apartment is sold annually. Variations over time have been fairly small. The most significant change occurred between 1991 and 1992 when the number of sold small houses dropped by some 40 per cent in one year. This could be explained by the simultaneous removal of the previous deferment opportunity. But at the time, Sweden also

suffered the greatest economic crisis since the war, which is why one may not be able to clearly trace the development to the tax reform. The introduction of interest on the transitional reserve in 2008 also coincides with a decreased turnover. During the previous five-year period, 2003–2007, the annual turnover of small houses and tenant-owner's rights was 3.3 and 10.3 per cent respectively, which may be compared to 2.9 respectively 9.6 per cent during 2008–2012. It is thus a matter of a 12 respectively 7 per cent drop. It appears as though the tax reform lead to certain lock-in effects. What effects may be contributed to “the moving tax” and what may be traced to other factors is impossible to determine by reviewing the collected data alone.

Rather than looking at pre-sold residential properties, we may look at the number of people who have moved. This includes not only the owner's market, but also the mobility of the rental market, such as young adults moving away from home, etc. As shown in Figure 6.6, between 12 and 13 per cent of all individuals move every year. According to this measurement, a small dip is also visible after the moving tax was introduced, from an average of 12.5 per cent 2003–2007 to 12.3 per cent in 2008–2012. However, the decrease is somewhat lesser than the drop in the early 2000s.

Figure 6.6 Quota of the population who have moved during the year



Note: These numbers refer to the quota of individuals who have changed their national registration address.

Source: Statistics Sweden.

The mobility of the residential property market is of course influenced by many other factors than taxes and other transaction costs. The years following the 2007 tax reform coincided with the global financial crisis which reasonably decreased the mobility. Therefore, it is impossible to draw any certain conclusions about lock-in effects from the collected time series. In order to make certain, individual data is required. Some studies on panel data from other countries suggest that transaction taxes may have significant effects, especially on the timing of a move in connection to tax changes.²³¹ In Sweden, Lundborg and Skedinger (1998) have studied a panel of small-house owners during 1986–1990 and found that the capital gains tax decreased the inclination to move to a less expensive residential property in connection to negative income shocks.

On the whole, variations in mobility over time have been small. Even if it is likely that today's capital gains tax with interest on the transitional reserve has a negative effect on the mobility of the residential property market, its effect seems fairly small compared to other factors that influence mobility. According to an OECD study, Sweden would actually belong to the group of OECD countries that have the highest mobility and the lowest transaction costs.²³² According to the study, the differences between countries are significant. In the Nordic countries, every fifth household move within a two-year period, while only every tenth German and every twentieth Eastern European household moves. In Sweden, the transaction costs on the owner's market (excluding capital gains tax) are only a few per cent, but in France and Belgium, they are 10 per cent or more.

A simple way of eliminating "the moving tax" would be to remove the interest on the transitional reserve. However, such a reform could be problematic. The majority would reasonably postpone the tax payment, and in time, the collected transitional reserves would be substantial. Deferment may be accumulated over a very long period of time, up until the owner extracts money from the residential property. A removal of the deferment interest would in this case create a quite heavily decreased effective taxation on residential properties from a point where residences are already taxed low. A natural way of compensating for such a decrease would be to

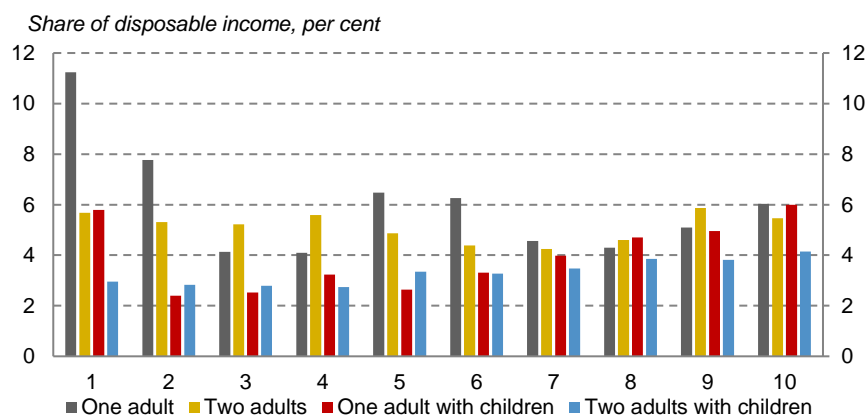
²³¹ See, for example, Best and Kleven (2017).

²³² Sánchez and Andrews (2011).

reintroduce a property tax proportionate to the value of the property. This could catch normal capital gains. The tax on capital gains could then be limited to gains beyond a normal level. Even if such a tax must be paid at the time of transaction, the lock-in effects would be minor.

An important issue is how a transition from capital gains tax to property tax would influence different income groups. As stated by the Council's 2016 report, a property tax proportionate to property value would predominantly be carried by high-income earners. Figure 6.7 illustrates how capital gains on residential properties are distributed throughout income groups. We can see that the capital gains corresponds to between 3 and 8 per cent of the disposable incomes for most of the household groups. There is a certain tendency that they weigh heavier on households without children than families with children. By contrast, there is no clear income profile.

Figure 6.7 Capital gains on residential properties 2016



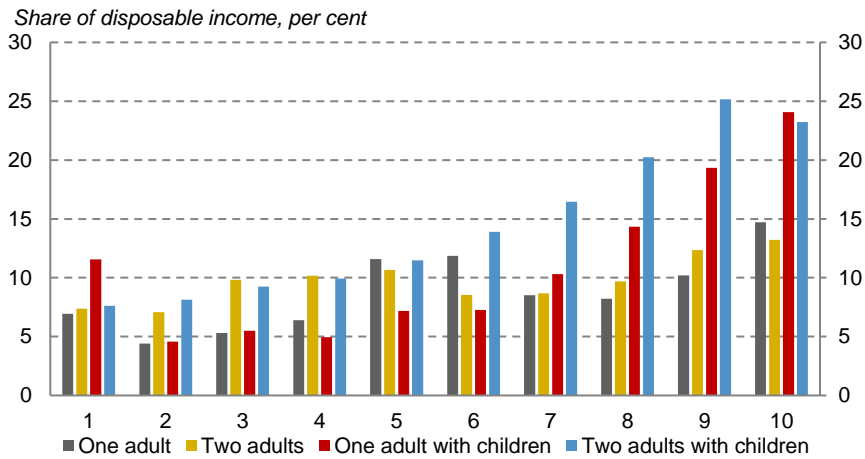
Note: The households are ranked by equivalised disposable income excluding capital gains, while the denominator and the numerator of the quota between capital surplus and disposable income include capital gains. Capital gains include previous deferments taken up until taxation.

Source: Statistics Sweden.

If we instead look at the transitional reserves in Figure 6.8, we can see that they have a clearer income profile and corresponds to 5–10 per cent of the income in the lower decile groups, but as much as 15–25 per cent in higher income groups. The cause of this difference is unclear. Since it is no longer profitable to have deferments, it

might rather be expected that households without capital or loan opportunities were the ones who foremost utilised deferment opportunities. But if so, it would give rise to a reversed distribution profile. A possible and reasonable explanation for the observed profile is that households with large deferments are older on average, since the deferments consists of capital gains from many years ago.

Figure 6.8 Transitional reserve 2016



Note: The households are ranked by equivalised disposable income excluding capital gains, while the denominator and the numerator of the quota between capital surplus and disposable income include capital gains.

Source: Statistics Sweden.

On the whole, we may draw the conclusion that consideration to the income distribution hardly is a reason to not combine a certain decrease in the tax of capital gains with a reintroduced property tax proportionate to the market value. Such a reform may benefit mobility of the residential property market and lessen the advantageous tax treatment of owned residences at the same time.

6.5 Investment savings accounts – tax-subsidised or not?

ISK was introduced in 2012. It is a form of saving intended for shares and other quoted financial assets. Taxation of assets in ISK is not based on the actual return (neither dividends nor rise in value) but is proportionate to a standard revenue that has been calculated as

the market value of the assets on the account multiplied with the government loan interest plus 0.75 percentage points. In practice, it is a kind of wealth tax akin to the box model. Since its introduction in 2012, the standard revenue has varied between 0.90 and 2.09 per cent, and it was at 1.25 for the income year of 2017. As of 2018 (the tax return of 2019), the standard revenue is raised to match the government loan interest plus 1 per cent. With an interest rate at 0.69 per cent (the year's average until 20 April 2018), the standard revenue of 2018 would be 1.60 per cent. This is then taxed at 30 per cent, the same rate as other investment incomes. Thus, the tax corresponds today to a wealth tax of 0.48 per cent.

ISK is generally seen – even after this year's rise – as a type of saving with favourable taxation. The motivation to introduce it was also because “savings in immediately owned financial assets ought to be encouraged”.²³³ A standard return of 1.60 per cent is also well below the normal return on shares. As of January 1995, the average yearly return on the Stockholm Stock Exchange has been 8.5 per cent (OMX Stockholm 30 including dividends), comparable to an average government loan interest rate of 3.8 per cent in the same time period. If ISK had been applied with current regulations during this period, only half of the share return would have been subjected to taxation: $(3.8+1)/8.5 = 0.56$.

That ISK is subjected to favourable taxation, however, requires qualification. It is true that the taxable standard return is significantly lower than the historical share return, and likely lower than the expected future return even considering the current low real interest rates. But at the same time, the owner incurs a greater risk if the shares are placed in ISK than if they are conventionally taxed, as the tax is still payable in the event of a decrease in value.

Therefore, the low standard rate can be viewed as a compensation for increased risk after tax. This idea can be specified with a reasoning based on the simplest portfolio choice possible. Consider a household that divides its financial wealth between two assets: bank savings, which provide low, risk-free interest rates, and a market portfolio, which yields a higher but more uncertain return. Supposedly, the household is averse to risk and strives toward a balance between high expected return and low risk. The risk can be

²³³ BP12 p. 343.

measured by the variance of the collected return, which depends on how much of the assets are placed in shares. A person with a strong aversion to risk may deposit all their money in the bank, while others may choose to invest some in shares; the more shares, the greater the variance. What matters is of course the variance in return *after* tax. For any given shareholding, that variance is greater with an ISK type standard tax than with a conventional income tax that meets the actual return; on an ISK, there is no marginal tax on deviations from the standard, and the shareholder bears all the risk. This means that ISK is equal to conventional income tax if the standard return rate is set low enough to compensate for this risk difference. It is not clear exactly what value on the ISK standard provides neutrality to income tax. With these assumptions, however, we may show that if the standard share return rate is set equal to the risk-free interest rate, the possible combinations between variance and expected return after tax in the portfolio (the household's "budget line") is exactly the same as if shares were conventionally taxed with the same tax rate (see Appendix 2).²³⁴

For a comparison of ISK and conventional taxation, it should also be taken into consideration that capital gains are taxed first when they are realised. The effective tax rate therefore ends up somewhat lower, below 20 per cent during long holding periods.²³⁵ The effective weight of evidence tax rate on shares (return plus capital gain) is therefore lower than 30 per cent, closer to 25 per cent.

With this information, it is not obvious that ISK generally is a favourably taxed type of saving. In order to assess this, we must determine which is the relevant, secure interest. The interest on deposits is practically zero today. But at the same time, many shareholders are in debt, and it stands to reason that the loans must be flexible if the shareholding is adjusted. If so, the tax on the ISK is on the low side of the risk-adjusted income tax on shares since the standard of 1.60 per cent is somewhat lower than current lending rates.²³⁶ Which interest is relevant to assess whether ISK is favourably taxed or not, however, is an empirical issue that is tied to the households' debts.

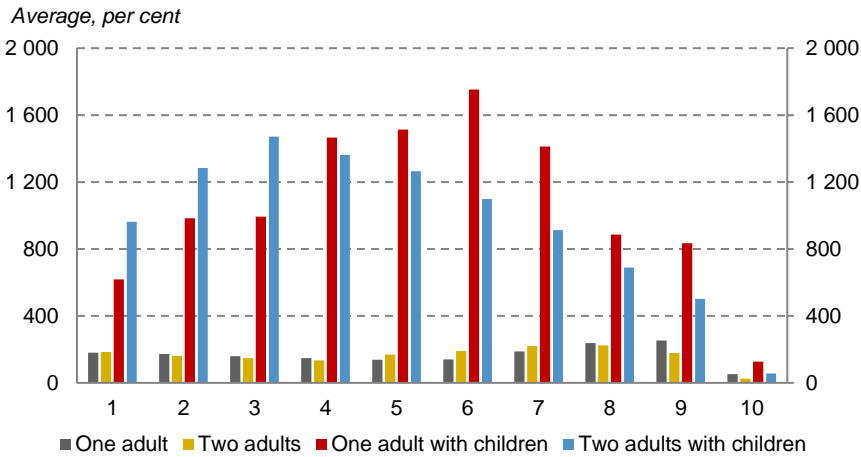
²³⁴ This correlation was discovered in the Swedish debate first by Lundberg (2017).

²³⁵ The difference is based on holding time and discount rate. With 10 years of holding and 3 per cent discount rate, the effective tax rate is 26 per cent, with 20 years of holding and 5 per cent discount rate, it is 19 per cent.

²³⁶ 2.04 per cent in a year, according to SEB.

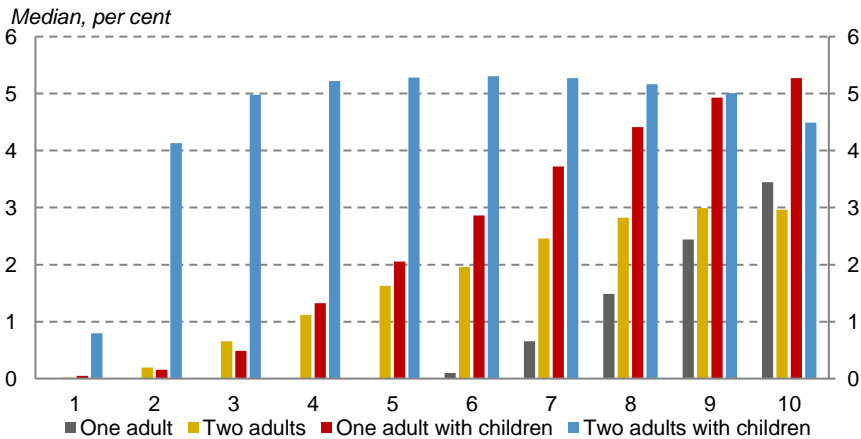
Figure 6.9 and 6.10 indicate how dependent households are on debt. The previous figure states average interests on debts as a percentage of all of the household’s interest and dividends earnings (incl. ISK). As shown, interests on debts are higher than interests and dividends for all groups except households in the highest decile.

Figure 6.9 Interests of debts in relation to income interests and dividends 2016



Source: Statistics Sweden.

Figure 6.10 Interest of debts in relation to disposable income 2016



Source: Statistics Sweden.

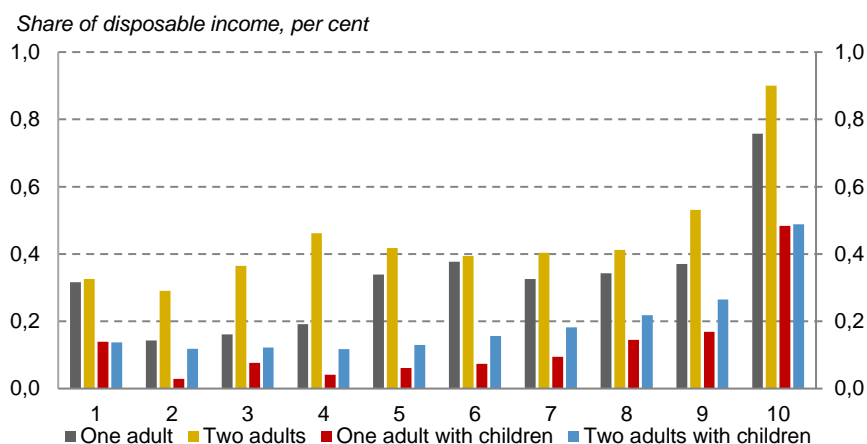
Figure 6.10 offers another indication, showing the median for interests of debts in relation to the median for disposable income. Here, we can see significant differences between single households, where the median is zero or negligible in most income brackets, and families of two adults and children, where the interests of debts correspond to 4-5 per cent of the income for all except the lowest decile. All in all, it is clear that the majority of households have significant interests of debts, and subsequently, it is reasonable to consider debts as the marginal financing source of the households' financial investments. Therefore, it is reasonable to compare to a lending rate. The standard interest rate of ISK is thus set on the low side of the relevant, secure interest rate. In conclusion, ISK is taxed somewhat favourably compared to conventionally income taxed financial assets.

ISK has quickly become a popular type of saving. In 2016 (2015), 1,312,000 (1,088,000) households in total had assets in ISK, which corresponds to 31 (26) per cent of all households. The average market value per household with ISK was SEK 419,000 (402,000). How, then, is the utilisation of ISK distributed among different household groups? Figure 6.11 accounts for the average standard revenue from ISK as a part of the disposable income. Not surprisingly, ISK represents a very small part of the households' incomes, consistently less than half a per cent in all groups. ISK makes more of a difference for households without children than for families with children and households in the highest decile group compared to other income brackets. To the extent that ISK can be viewed as favourably taxed, this indicates a redistribution to these groups.

The fact that ISK is of greater significance to households without children and households with high income reflects that they own more shares and have more collected net wealth. If ISK was believed to be imposed with a highly favourable tax, we would expect the households to move the majority of their shares to ISK. We may then establish that most households that own shares also have ISK. In relation to the number of households that reports dividends income from shares (excl. family businesses), the households with ISK amounted to 76 per cent. The quota between standard revenue from ISK and dividend income from shares (excl. close companies) can illustrate how much ISK is utilised. In Figure 6.12, this quota is

basically the same for all household categories with one clear exception: high-income earners use ISK to a far less extent than other households. For households in decile group 10, the revenue from ISK constitutes less than 10 per cent of the dividend, while the corresponding proportion is at 25-30 per cent for the majority of the other groups. With a dividend payout ratio of 2-3 per cent, the value of the household's shares in ISK in general are somewhat lower than other shares, and for households in decile group 10 considerably lower.

Figure 6.11 Return on ISK account 2016



Source: Statistics Sweden.

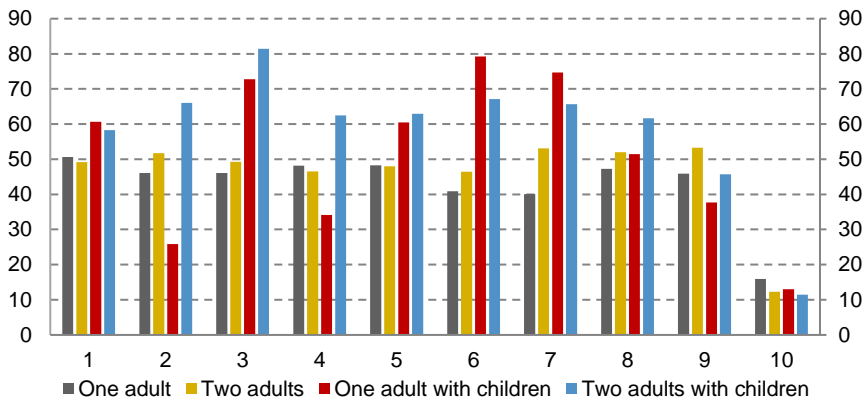
There may be several explanations for why the households still keep a large part of their directly owned shares out of ISK. Firstly, the capital gain of existing shareholdings must be taxed in connection to the shares' transaction to ISK. Second, only shares with a quotation on a market place are placed in ISK. Third, as discussed above, the tax benefit is not that great. One can speculate about the reasons why the richest households utilise ISK to such a low degree. A contributing factor is likely their greater holding of unquoted shares compared to other groups.

Investment savings accounts were introduced with the explicit purpose of stimulating households to directly own shares by advantageous taxation. Direct ownership of shares is highly concentrated in households of higher income brackets, foremost the highest decile group. Thus, these are first and foremost benefited by

ISK. However, keeping in mind the uncertainty of the return after tax on ISK compared to regular income tax, the tax benefit is fairly small.

Figure 6.12 Return on ISK account in relation to dividends of shares (excl. K10) 2016

Andel av utdelning från aktier, procent



Source: Statistics Sweden.

6.6 Assessments and recommendations

The tax reform of 1991 aimed toward a uniform taxation of the households' capital gains. This uniformity has been split by two reforms in particular: the replacement of the property tax with a property fee and the introduction of investment savings accounts. Also, the taxes on inheritance, assets and gifts have been abolished. All in all, these reforms have entailed a lower average taxation on investment income, greater differences between the taxation of various forms of investment income and a greater asymmetry in relation to deduction rates. These changes have consistently benefited households with higher income.

The introduction of investment savings accounts has also entailed a certain alleviation of the taxation on financial assets, and that tax reform, too, has a regressive distribution profile. With the higher standard interest rate that comes into effect in 2018, however, assets in ISK cannot be considered low taxed compared to other assets, especially not compared to residential properties.

The households' capital incomes consists for the most part of capital gains. Such incomes are normally taxed when they are realised. The taxation thereby acts inhibitory on sales and counteracts mobility on the residential property market. This gives grounds for decreasing in different ways the taxation that is tied to the sale. ISK represents a radical step in this direction by disconnecting the tax from the actual capital gain, regardless if it is realised or not. However, the residential property tax has moved in the opposite direction. The element of running standard tax has been reduced, meanwhile the capital gains tax at the time of sale has been tightened and interest on deferment has been introduced. That the two tax reforms have moved in opposite directions is especially paradoxical since the problems with lacking mobility are more apparent on the residential property market.

A review and reform of the capital taxation is urgent. It is difficult to completely survey the consequences of the split uniformity. A future tax reform should be formulated so that property taxes to a greater extent are levied on a current basis in relation to the value of the property and to a lesser extent based on the realised capital gain.

7 The households' incomes

In this chapter, we provide an overview of the households' income development. A relatively big part of the chapter concerns the capital incomes' effects on the income distribution, since they have contributed substantially to an increased income inequality in the last twenty years.

The income term used in the chapter is what is usually used in distribution analyses, i.e. equivalised disposable income. The measurement is also called the household's *financial standard*. The disposable income consists of incomes from work, capital and business activity as well as taxable and tax-free transfers. The equivalised measurement, which is calculated by SCB, is attained by dividing a household's total disposable income by a consumption weight based on a consumption unit scale (equivalence scale), considering the household's composition.²³⁷ All individuals in the household are allocated the same equivalised disposable income. The merit of this approach is that enables comparisons between households of different compositions. It also enables analyses of the financial standard distribution for the entire population.

Since the Spring Fiscal Policy Bill of 2017, the Government presents an expanded income concept that aims to capture the value and distribution of publicly financed welfare services.²³⁸

7.1 Distribution of disposable incomes

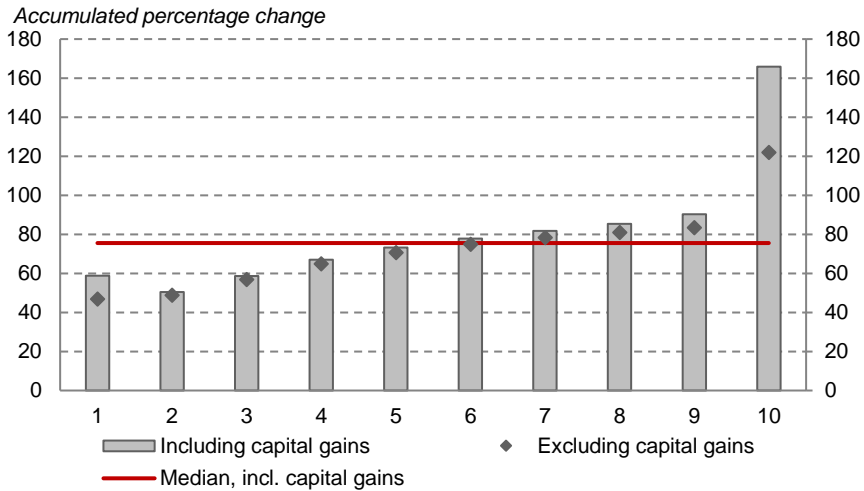
Real incomes have risen in all groups since the mid-1990s. In the years 1995–2016, the real median income rose by nearly 76 per cent, which corresponds to an average increase of 2.7 per cent per year. Individuals of all income groups – or decile groups – have had an increased economic standard, but the income development has not been evenly distributed. In 1995, an average individual of the first decile group had 64 per cent of the median income earner's financial standard. In 2016, this percentage had been reduced to 54. The

²³⁷ Example: A cohabiting couple with two children has a disposable income of SEK 490,000. The household has a total consumption weight of $1.51 + 0.52 + 0.42 = 2.45$. Therefore, the household's disposable income per consumption unit is $490,000/2.45 = \text{SEK } 200,000$. This means that the household has the same financial standard as a person living alone with a disposable income of SEK 200,000. Source: Statistics Sweden.

²³⁸ VP17, Appendix 2, p. 8.

corresponding figure for an individual in the tenth and highest decile group rose from 160 per cent to 179 per cent in the same time period. The highest incomes has thus increased more than the median income, meanwhile, the lowest incomes have dragged behind. This pattern is clearly visible in Figure 7.1.

Figure 7.1 Economic standard in different decile groups 2016 compared to 1995



Note: The change refers to the average disposable income in respective decile group since the base year, expressed with the price level of 2016.
Source: Statistics Sweden.

The lowest incomes had a real increase by 60 per cent between 1995 and 2016, which was less than the median increase. In the same time period, the highest incomes increased by 160 per cent. Discounting realised capital gains, the real incomes of these groups rose by 47 respectively 122 per cent – still a remarkable difference.

Since 2014, the development has been steadier compared to the total time studied. The last two years, the real incomes increased essentially equally in decile groups 2-9. The lowest incomes increased significantly more rapidly and thereby eliminating a fraction of the distance to the median. The highest incomes continued to represent the by far most rapid increase. The reason why the highest incomes have outstripped the median is that the capital gains have increased substantially, which we will return to in the next chapter.

In-depth analysis 7.1 The distribution effects of the measures in BP18

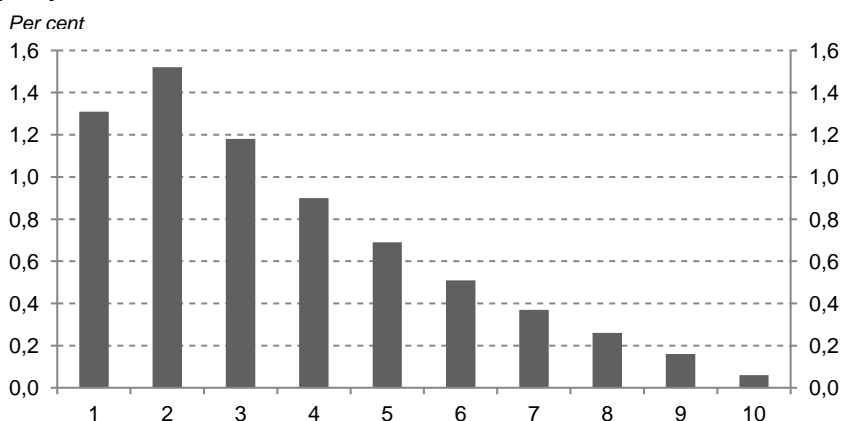
Since 2017, SCB calculates how the suggestions of the budget proposal influences the households' economy. The calculations are worked out using the micro-simulation model FASTT. In this in-depth analysis, the results of SCB's calculations are summarised. Disposable income per consumption unit is consistently used as a measurement of economic standard.

In BP18, several changes are implemented that have effects on the households' economy. The most fundamental changes in the tax area are that taxation is lowered for both pensioners and persons with sickness benefits and activity compensation. At the same time, the taxation on investment savings accounts (ISK) is raised.

Also, extensive changes are made in certain transfer systems; child benefits and housing allowance are raised for families with children; the study grant is raised for students in upper secondary school, university and college; the housing supplement and financial support for the elderly are raised as well as the upper limit of the health insurance and the level of guarantee in the sickness benefits and the activity compensation.

Figure 7.2 shows the effect of the suggestions in BP18 on the disposable income of different groups.

Figure 7.2 The effect on economic standard in different decile groups



Note: The bars show the average change in economic standard for all individuals in respective decile group as a result of BP18's changes in regulation.

Source: SCB (2018).

Approximately 70 per cent of the population is influenced to some degree by the changes. Children and pensioners are affected the most. On average, the financial standard rises by 0.5 per cent, but the effects vary between different income groups in the population. As shown in Figure 7.2, those of low or medium high income are the ones foremost benefited by the regulation changes. For example, the financial standard rises by an average of 1.5 per cent (amounting to SEK 2,301 per year) in decile group 2, but only by 0.2 per cent (SEK 652 per year) in decile group 9. Approximately one per cent of the population will have a slightly lower economic standard, primarily as a result of the increased tax on ISK. These individuals are for the most part found in the highest income group.

The Gini coefficient, which measures the concentration of incomes, drops slightly as a result of the regulation changes.²³⁹ Thus, the income distribution becomes somewhat more even. However, the change is small, from index value 0.307 to 0.305.

Source: SCB (2018).

The other end of the distribution lags behind foremost because the development of several transfers fail to keep up with other incomes, which the council mentioned in the report of 2015.²⁴⁰ A FASIT simulation from the Ministry of Finance shows that almost half of the difference between the income increase in the lower end of the distribution and the median is explained by the transfers lagging behind.²⁴¹ Some taxation changes are also likely to have contributed to the increased income differences between the median and the lowest incomes. The earned income tax credits e.g. have helped increase the incomes in the mid-range distribution rather than the lower income levels.

The income development of the lower income levels has also been influenced by a series of structural changes that have been implemented since the late 1980s, e.g. in the composition of the population. In-depth analysis 7.2 in this chapter covers a OECD study that has looked into the influence of such factors on the income distribution.

²³⁹ The Gini coefficient is described in greater detail in Appendix 7.2.

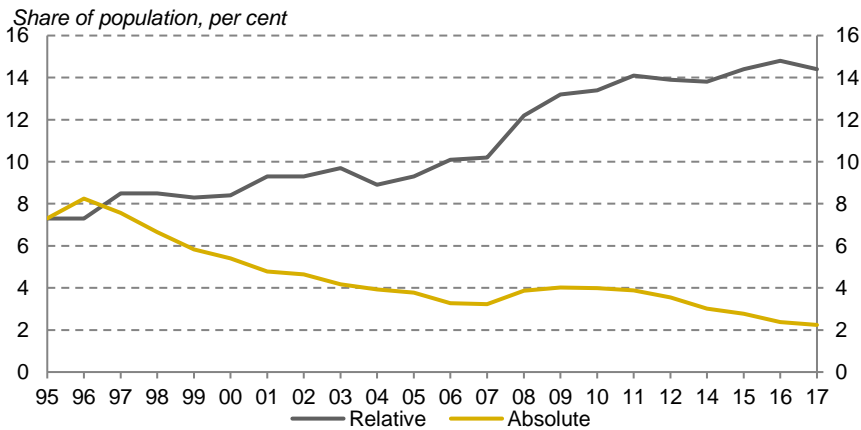
²⁴⁰ See Fiscal Policy Council (2015).

²⁴¹ The model calculation does not include second-order effects or dynamic effects, and the results should therefore be interpreted with caution. See BP18, Appendix 2.

7.1.1 Different measurements of poverty

There are several ways of describing the existence of poverty in a country’s population. A common measurement of poverty is *low, relative economic standard*, defined as an income below 60 per cent of the median income. According to this measurement, which is also called relative poverty, poverty in Sweden has increased continuously since 1995 (Figure 7.3). The development was particularly dramatic between 2007 and 2011; the proportion of poor people rose by some 4 per cent – more than the previous ten-year period. There are several explanations for this, e.g. changes in tax and transfer systems which enhanced the income differences between the mid and lower parts of the income distribution. This effect was intensified when the unemployment rate rose in the financial crisis of 2008. Since 2011, the proportion of poor people has increased somewhat, but the latest available statistics indicate a slight reduction between 2015 and 2016.

Figure 7.3 Proportion of individuals in households with low economic standard



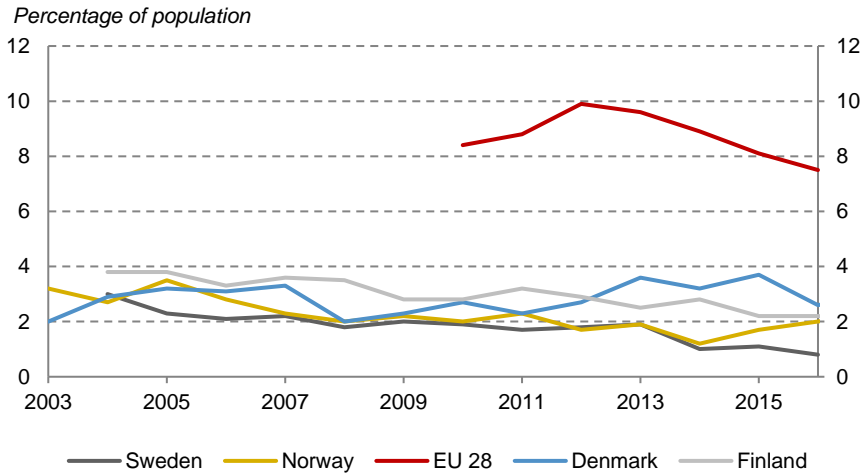
Source: SCB and the Ministry of Finance.

If we instead looks into how the households’ income standard relate to the price adjusted median income of 1995, a measurement of absolute poverty is received. In absolute terms, the proportion of poor people has been reduced since 1996, parallel to the rise of the real incomes in the lower income levels. All in all, this entails a higher living standard for Swedish households in general but that the incomes for those with a relatively low economic standard have

continued to lag behind the median income. Persons with a weak connection to the labour market, single parents and single pensioners are overrepresented among those with a low economic standard. Non-natives, especially those who have resided in the country for a short time, are poor to a greater extent than natives. Cohabiting couples, both working and pensioners, generally run a lower risk of suffering from poverty.

The European Commission has developed an index to complement the common income measurements. As opposed to the measurements discussed thus far, a direct measurement of an individual's living standard. This index – the proportion of the population with very low material standard (*severe material deprivation*) – is lower in Sweden than any other EU country as well as lower than any of our Nordic neighbours (Figure 7.4).²⁴² Further, the proportion of financially vulnerable has been reduced in the last few years, according to this measurement. Both measurements of absolute poverty capture Sweden's development in similar ways.

Figure 7.4 Proportion of the population with very low material standard



Source: Eurostat and Macrobond.

²⁴² Very low material standard is defined by the inability to afford four of the following: rent/housing loan, heating costs, regular meat or protein consumption, vacations, TV, washing machine, car, telephone.

In-depth analysis 7.2 Structural factors of the increased income inequality

The factors that are most often used to explain the increased income distribution is changes in the labour market function and in the policy of redistribution. But this is not the entire explanation. It is likely that the demographic development and structural changes also have contributed to a greater income inequality in Sweden since the late 1980s.

An OECD study looks closer into the effect of a number of such structural changes that have occurred in Sweden: The proportion of youths (18–24 years old) of the population has decreased, meanwhile, the proportion of seniors (64+) has increased. The households' composition has changed drastically, and more and more Swedes live in single households today. The proportion non-natives has almost doubled in this period. In the 1980s, the majority of migrants consisted of Nordic labour immigration, while migrants now are mostly refugees from outside the EU. The education level in Sweden has increased substantially; the proportion with less than 9 years of education has decreased by two thirds during this period, and the proportion with a university degree has increased. The industry structure – or the labour force composition – has also gone through major changes, with fewer workers in the manufacturing and transport industry, and more in service professions, IT and finance.

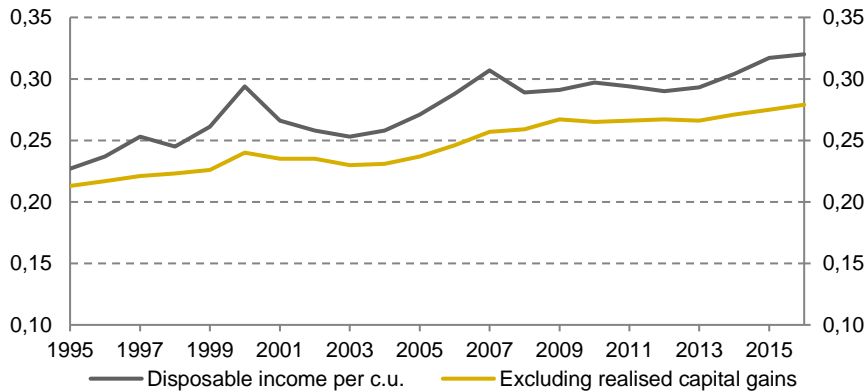
The study finds that approximately 70 per cent of the increased distribution of incomes before taxes and transfers between 1987 and 2013 can be explained using these factors. Taxes and transfers have counteracted the tendency significantly, but even if these are included in the income concept, the structural factors can be attributed to some 40 per cent of the increased inequality. The factors that cause the most change is the household structure, the age composition and the industry structure. The volume effects of the migration explains a relatively small part of the increase in the Gini coefficient, but a bigger part of the rise in relative poverty. However, these results are likely underestimations of the actual influence that these surges in migration have had, since they only take into account the increased proportion of non-natives in the population and not the composition of the group.

Source: Robling and Pareliussen (2017) and OECD (2017a).

7.2 The Gini coefficient and the significance of capital gains

Gini coefficient, which measures income distribution, has followed a rising trend for a long time (Figure 7.5).²⁴³ Since 1995, the Gini coefficient including capital gains has increased by more than 40 per cent. A predominant part of the development is due to the collected capital gains distribution and development; if these are excluded, the increase is closer to 10 per cent.²⁴⁴

Figure 7.5 The Gini coefficient in Sweden 1995-2016



Source: Statistics Sweden The households' economy (HEK) 1995-2010; Incomes and taxes (IoS) 2011-2016.

The capital incomes consists partly of capital gains and partly of interests and dividends. Both capital gains and other capital incomes have become increasingly important to the average incomes of the population; in the years 1995–2005, they constituted 6 respectively near 5 per cent of the factor incomes, while since, they have represented near 9 respectively 7 per cent (Figure 7.6).²⁴⁵

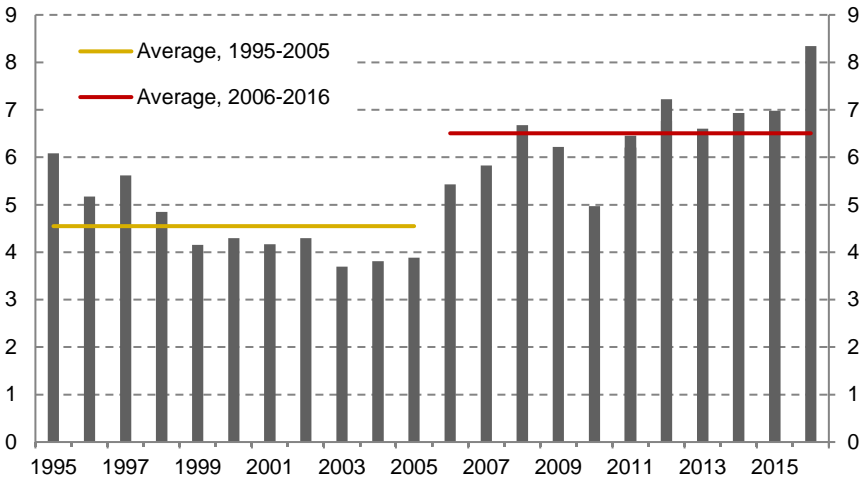
²⁴³ Gini coefficient assumes a value between 0 and 1. The extreme of 0 indicates that the incomes are exactly equally distributed, and 1 indicates that all incomes go to one individual. The Gini coefficient has a mathematical ability which is useful when interpreting changes in the coefficient. By multiplying the coefficient by two, one receives a measurement of the expected income difference in per cent between two randomly selected individuals of the population. If the average income is SEK 200,000, and if the Gini coefficient is 0.25, the expected difference can be expressed as $2 \times 0.25 \times 200,000$ – i.e. SEK 100,000. If the Gini coefficient instead is 0.30, the expected difference is $2 \times 0.30 \times 200,000 = \text{SEK } 120,000$.

²⁴⁴ The Gini coefficient excl. capital gains increased from just over 0.2 in 1995 to approx. 0.24 in 2015. See VP17, Appendix 2, Figure 3.5.

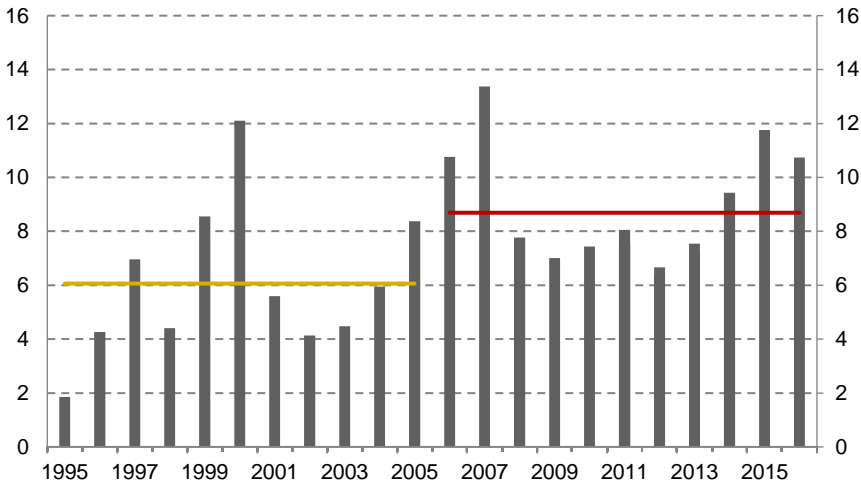
²⁴⁵ Factor incomes is the sum of employment incomes, business incomes and capital incomes.

Figure 7.6 The capital incomes' proportion of the households' factor incomes has increased

a) Interests and dividends



b) Realised capital gains



Source: Statistics Sweden.

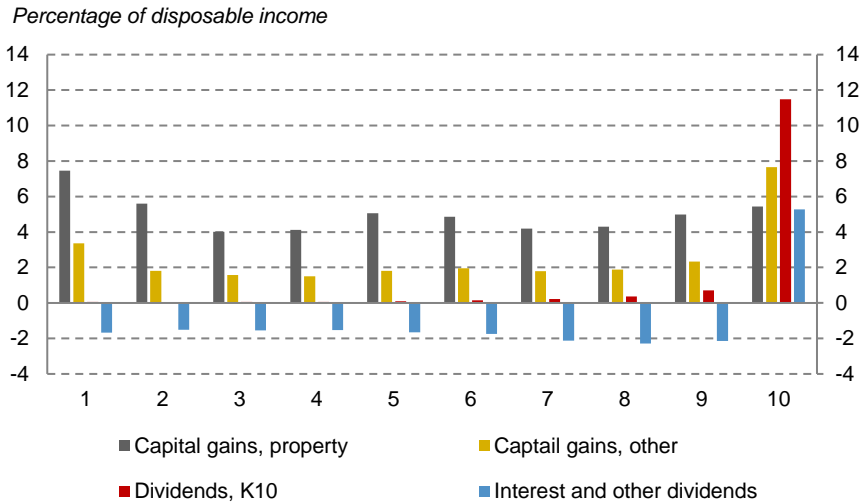
The capital gains proportion of the households' incomes vary greatly (image b). They depend on the value development and the return on financial assets, e.g. shares. But they also depend on the return on other kinds of investments, e.g. residential properties. Furthermore, these gains are realised at a single occasion, even if the asset development (rise in value) happens gradually. The gains increased

substantially just before the dot-com crash and then before the financial crisis. In the last few years, they have regained significance for the households’ disposable incomes.

Also interests and returns vary according to the development on the financial market, but they are not as volatile as the capital gains. A contributing factor to the increased extent of these types of incomes is the tax reform of 2006 which increased the opportunities to receive compensation in the form of returns instead of wages.²⁴⁶

The investment income is greatly concentrated to the upper bracket of the income distribution. Figure 7.7 shows how large a proportion of the average income in each decile group investment income comprises.²⁴⁷

Figure 7.7 Investment income is unevenly distributed



Note: The figures are for 2016. Other capital gains consists primarily of realised capital gains on quoted shares and funds. Households are ranked by disposable income per consumption unit excluding capital gains and divided into ten income groups (decile groups). Thereafter, investment income is related to disposable income including capital gains in each income group.
Source: SCB and own calculations.

²⁴⁶ Incentives and opportunities of “income shifting”, or reclassification of incomes in a close company, has increased remarkably as a result of the changes of the 3:12 regulations introduced in 2006. See ESO report “Income Shifting in Sweden – An empirical evaluation of the 3:12 rules” by Alstadsaeter & Jacob (2012).

²⁴⁷ Note that this way of illustrating the investment income disparity underestimates the bias in the distribution of investment income, as the investment income is related to income levels which vary drastically from one income group to the next. An alternative way of illustrating the concentration of investment income is to show how large a proportion of the combined investment income falls to different decile groups. See, for example, VP18, Appendix 2, p. 3.2.

For an average individual in decile group 10, the combined investment income accounted for 30 per cent of the disposable income. In other decile groups, investment income constituted on average 5 per cent of the disposable income. The most obvious difference is to be found in dividends from close companies in accordance with the 3:12 regulations. These are greatly concentrated to the top decile group, which in practice entails a shift from income from employment to investment income. The net of interest and other dividends is negative in all decile groups apart from the top group, where the net amounted to close to 6 per cent of disposable income in 2016. Financial capital gains accounted for around 7 per cent of income in decile group 10 and less than 2 per cent in other decile groups.²⁴⁸ Realised capital gains upon the sale of property are considerably more evenly distributed when related to disposable income.

7.2.1 Different income types' contribution to the Gini coefficient

One way of analysing the development of income inequality is to break down the Gini coefficient into different income types. The Council has had SCB perform this type of decomposition of the Gini coefficient for the period 1995-2016. Households' disposable income has been divided into the eight income types of wage, interest/dividends, capital gains, other forms of income, pension, other taxable transfers, tax-free transfers received and transfers paid (primarily taxes). The method used is a "concentration index", which measures how each income type is distributed in relation to the distribution of disposable income among the population. The total contribution from each income type depends not only on the concentration index, but also the income type's proportion of disposable income. The results are shown in table 7.1.

Employment income constitutes by far the largest contributor to the Gini coefficient (row 1 in the table). This is not because this income type is the most unevenly distributed; it is because it

²⁴⁸ One exception is decile group 1, where financial capital gains constituted just over 3 per cent of disposable income. This income group is however very heterogeneous and the disposable income likely does not provide an accurate picture of the group's standard of living. Individuals who report income abroad and not in Sweden, for example, can be found in this income group.

constitutes the bulk of the disposable income. The contribution to the Gini coefficient attributable to employment income has decreased since 1995, which is at least partly due to the fact that wages' proportion of the disposable income has decreased. A contributory factor to this is likely that the dividends in accordance with the 3:12 regulations have increased (see above).

The combined investment income has contributed most to the increase in income inequality. Both capital gains and other forms of investment income have contributed to the development.

Positive transfers have counteracted the tendency towards increased income differences somewhat, but the contribution for a single year is small. As a result of rising capital gains, capital taxes have been more redistributed, but the aggregated income taxes (transfers paid, last row in table 7.1) have contributed to greater income disparity overall. This is primarily a result of the amount of tax in relation to disposable income decreasing, partly as a result of the introduction of earned income tax credit and the abolishment of property and wealth tax. The taxes' concentration index, on the other hand, remains largely unchanged in 2016 when compared with 1995.²⁴⁹

Table 7.1 Different income types' contribution to the Gini coefficient

<i>Gini units</i>	1995	2016	Change
Employment income	0.315	0.301	-0.014
Investment income	0.050	0.161	0.110
<i>Capital gains</i>	<i>0.026</i>	<i>0.091</i>	<i>0.065</i>
<i>Interest and dividends</i>	<i>0.024</i>	<i>0.069</i>	<i>0.045</i>
Other income	0.007	0.011	0.004
Transfers received	0.008	-0.005	-0.013
<i>Pensions</i>	<i>0.047</i>	<i>0.020</i>	<i>-0.027</i>
<i>Other taxable transfers</i>	<i>-0.009</i>	<i>-0.010</i>	<i>-0.001</i>
<i>Tax-free transfers received</i>	<i>-0.029</i>	<i>-0.015</i>	<i>0.014</i>
Transfers paid	-0.153	-0.145	0.008
Total	0.227	0.322	0.095

Note: A positive contribution means that the income type contributes to greater income inequality. The opposite is also true.

Source: Statistics Sweden.

²⁴⁹ See, for example, VP18, appendix 2.

7.3 Assessments and recommendations

The real economic standard has increased for all income groups between the years of 1995 and 2016. The distribution of income has become more and more uneven, however, both by means of the lowest income types experiencing weaker development and the highest experiencing considerably stronger development than the median income. The key reasons behind this are that investment income has increased and become more concentrated to a high income bracket and that the transfers have not developed in line with the average income. The disparity of employment income has however decreased. This may partly be a result of the changes to regulations concerning dividends in close companies, which in practice have entailed that part of employment income in the upper income bracket has been transformed into investment income.

A number of structural changes have also contributed to increasing income inequality. The key changes seem to be an increase in the proportion of single households, a demographic development towards a larger proportion of elderly (who have a lower income), and a restructuring of trade and industry which has entailed fewer people working in the manufacturing industry and more in more diversified service professions.

Poverty has decreased in Sweden since 1996. The proportion of people with a low material standard of living is lower in Sweden than in the neighbouring Nordic countries and considerably lower than the EU average. Relatively speaking, however, a larger proportion of the population is considered poor today than just over twenty years ago. This is due to the low income bracket not developing in line with the median income. The latest statistics indicate, however, that the trend of a rising proportion of relative poverty may have been broken.

Appendix 1: Labour market

Changes in terms of taxation and transfer payments, as well as within the active labour market policy, have different effects on the function of the labour market. This appendix provides a general description of a number of changes that the Government has implemented in the labour market area during its term. Forms of support have been added or changed in order to more accurately reach the individuals furthest away from the labour market. Other changes, such as those affecting unemployment and sickness benefits and income tax, impact on the incentives to work.

A1.1 Subsidised employment

In BP18, the Government provided an overview of the flora of subsidised employment. Five different forms of support (special recruitment support, enhanced special recruitment support, trainee positions in the welfare sector and professions with a shortage of trained labour, and entry jobs) were collectively placed in the new subsidy form of **introductory jobs**. The new introductory positions are intended for participants in the job and development guarantee programme and for new arrivals, and they can be flexibly combined with training. The subsidy level is 80 per cent up to a ceiling of SEK 20,000 per month. At the same time, the ceilings in different subsidised employments were harmonised so that they also amount to SEK 20,000 per month for extra services and fresh-start jobs.

The **extra services** were introduced in November 2015 for welfare professions. The aim of the support is to offer people in long-term unemployment, who have been part of the job and development guarantee programme for more than 450 days, a chance to find an employment with a salary in line with a collective agreement.²⁵⁰ The employer receives compensation for 100 per cent of the salary cost for a maximum of 2 years.²⁵¹ In BP17, the target group for extra services was expanded to also include new arrivals and to cover work at 100 per cent of full-time rather than the

²⁵⁰ The extra services are intended to gradually replace the employment phase of the job and development guarantee programme (i.e. phase 3). The division of the job and development guarantee programme into different “phases” was removed in 2016. The discontinuation of the employment phase must be completed by the end of January 2018.

²⁵¹ VP15 p. 51.

previous 75 per cent.²⁵² When the extra services were introduced, the Government expected the scope to be 30,000 in the longer term. In the subsequent budget bill, the ambition was lowered to 20,000 up until 2020. Historically, it has proven difficult to quickly build volumes within new measures, which has also been the case in the extra services. Last year, an average 5,000 people were employed through this support form each month. However, the number increased rapidly in the late autumn, and in March 2018, it amounted to 13,977 (see Section 5.2.2).

Trainee positions were introduced in 2016 and constitute a subsidised form of employment, which is combined with regular vocational training (at least 25 per cent of full time). The measure was originally targeted at young people between the ages of 20 and 24 years. The target group was later expanded to also include new arrivals and people in long-term unemployment aged 25 years or older. At the same time, the requirement for upper-secondary education was removed. The trainee positions primarily involve professions within the welfare sector, but also professions where there is a great shortage of labour.²⁵³ The aim was initially for the trainee positions to eventually employ a little over 30,000 individuals. In June 2015, KI made the assessment that in the longer term, the trainee positions would involve approx. 5,000 people. However, since the introduction, there have only been very small volumes. In March 2018, only 373 people were receiving this form of support. Following the overview of subsidised employment forms in BP18, the trainee positions were removed.

As of 2017, the Government has also introduced **modern preparatory jobs** in the public sector. All in all, 5,000 people are expected to be employed through this programme by 2020. The government agencies receive the compensation required for those employed to have a salary and working conditions in accordance with collective agreements. The job must involve “tasks of public benefit” which are not currently being performed, and which relate, for example, to simple administration, digitisation, nature conservation and protection of our cultural heritage. The preparatory jobs are based on existing forms of employment support (extra services) and

²⁵² The extra services also became available in the non-profit sector.

²⁵³ See Arbetsförmedlingen (2017a) p. 80.

may last for a maximum of 2 years. In March 2018, there were 1,147 people employed within the programme.

The fresh-start jobs have the greatest scope of the subsidised employment forms, amounting to an average of approx. 41,000 per month in 2017. They were introduced by the previous government on 1 January 2007 and target those who have been outside of the labour market for a longer period of time. Fresh-start jobs mean that an employer that hires an individual who has been off the labour market for at least one year will receive a hiring subsidy for a period corresponding to that during which the person has been unemployed. At the introduction of the subsidy, this was equivalent to one employer contribution (i.e. 31.42 per cent of the salary) for work in the private sector. The subsidy was expanded in 2008 to include the entire labour market and was doubled in 2009 to cover two times the employer contribution (i.e. 62.84 per cent of the salary). The fresh-start jobs differ from other forms of support in that they are not provided through the public employment service; instead, any unemployed person who can find an employer willing to hire them is entitled to this support. In practice, however, they constitute a subsidised employment. The fact that the fresh-start jobs constitute a right also means that Arbetsförmedlingen cannot prioritise the jobseekers who are furthest from the labour market in the way they are able to for other forms of subsidised employments. This entails large displacement effects; according to a study from IFAU, approximately 63 per cent of all employments within fresh-start programme would have come about even without the subsidy.²⁵⁴

In BP17, the fresh-start jobs were changed to target the subsidy to a greater extent towards individuals who have been unemployed for a longer period of time. The subsidy was halved for those who have been unemployed for less than 2 years, and was increased to 2.5 times the employer contribution for individuals who have been unemployed for more than 3 years and for new arrivals. The maximum period during which the subsidy can be paid was shortened to 2 years from the previous 5. In its new form, the subsidy is likely more effective, and causing less displacement, as it is better targeted to those individuals who are very far removed from the labour market.

²⁵⁴ See Liljeberg, et al. (2012).

As a result of the harmonisation of subsidised employments in BP18, the wage ceiling for the fresh-start jobs was lowered to SEK 20,000 per month, to match that of the introductory positions.²⁵⁵ This is likely to reduce demand for the support. Last year, there was a decreasing trend in the number of fresh-start jobs, and in March 2018, there were 32,900 employed through the programme. In Arbetsförmedlingen's assessment, this trend will continue, and they expect fresh-start jobs to involve an average of 28,500 individuals in 2021.²⁵⁶

The target group for the **vocational introduction**, which was introduced in 2014, has been extended to also include new arrivals and people in long-term unemployment, aged 25 years or older.²⁵⁷ The vocational introduction programme combines salary subsidies with work placement training, providing an opportunity to learn a profession in the workplace in combination with training or supervision, while the participant is offered a salaried position. The vocational introduction programme is yet another example of the difficulty in quickly achieving large volumes in new measures. Last year, the programme had approx. 700 participants. The fact that the programme now includes new arrivals is positive; however, compared to other available subsidies that an employer can choose from, it is to be expected that the interest in this one is limited. The fresh-start programme offers a higher subsidy rate, for example, and it is not combined with education.

A1.2 Education initiatives

When the Government came to office in 2014, a new adult education programme was initiated. The **Adult Education Initiative** aims, for example, to increase the establishment opportunities of new arrivals in society and in the labour market.²⁵⁸ It was initiated in VP15, in which it was allocated funding for 2,800 more places within Komvux and Yrkesvux in 2015, and 10,000 places for the years 2016–2018. Funding was also allocated to the Folk High Schools corresponding

²⁵⁵ A requirement regarding collective agreements was also introduced.

²⁵⁶ See Arbetsförmedlingen (2018b).

²⁵⁷ The support for vocational introductions was introduced by the previous government and entered into force in 2014. The aim was for the measure to cover 30,000 young people under the age of 25 years.

²⁵⁸ VP15 p. 66.

to 750 places in 2015 and 2,000 for 2016–2018. At the same time, the universities were allocated greater resources, corresponding to 14,000 places in 2018.²⁵⁹ In subsequent budget bills, the Government has announced reinforcements of the reform, which, once completed in 2021, shall cover 93,000 places for students at Yrkesvux, Komvux, universities and university colleges.

In order to form an independent opinion about the size of the Adult Education Initiative, it must be placed in relation with the demographic need, though it is difficult to assess the demographic need for various types of education. A rough reasonable measurement would be to increase the number of places for students at the same rate as the increase in population, in order to keep educational possibilities at the same level. In the December 2016 issue of *Konjunkturläget*, KI analysed the Government's education initiatives within Komvux and Yrkesvux based on the levels stated in BP17 in relation to the population changes in the coming years. The government-funded places for students in Yrkesvux in coming years are provided on the condition that the municipalities fund at least as many places as are funded through the state subsidy. In this case, KI's analysis indicates that the number of places at Yrkesvux will increase both in quantity and relative to the population aged 20–64 in coming years. On the other hand, the increased number of places at universities and university colleges is not expected to correspond to an increased number of places relative to the population aged 19–30 years.²⁶⁰

It is difficult to measure the effects of the Adult Education Initiative's effects on the labour market. In the longer term, it contributes to a higher employment rate, as it raises the competence of the unemployed, adjusting it to demand. In the short term, it may also entail a slightly lower level of unemployment, if people leave the labour force in order to study.

In conjunction with the Adult Education Initiative, the Government has also introduced an **education contract** and a **90-day guarantee for young people**. The 90-day guarantee sets a limit for how long a young person may be unemployed before they are

²⁵⁹ VP15 p. 49.

²⁶⁰ See in-depth analysis "Long-term developments in the labour market", National Institute of Economic Research (2016b).

offered a job: an initiative that leads to employment or education.⁻²⁶¹ The education contract entered into force on 1 August 2015. The aim is for young people between the ages of 20 and 24 who have not completed an upper-secondary education to start or return to their studies with the goal of obtaining an upper-secondary qualification or equivalent knowledge. The education contract is an agreement for a young person to study within municipal adult education (Komvux) or folk high school with the aim of completing an upper-secondary education programme.²⁶²

The incentives to study have also been reinforced through the **Education Entry Grant**.²⁶³ The grant is aimed at individuals with a short education, who have been unemployed for more than six months, and it can be used for studies at compulsory or upper-secondary level. The grant is approx. SEK 9,100 per month for a maximum of 50 weeks. The Government estimates the scope at approx. 10,000 full-time places.

BP18 introduced **compulsory training/education** for new arrivals. Education being compulsory means that all new arrivals who take part in Arbetsförmedlingen's establishment initiatives, and who are deemed to be in need of training/education in order to find work, can be instructed to apply for and undergo training/education at the risk of otherwise losing their benefits.

A1.3 Taxes and transfers

In VP15, the Government suggested that the level of the highest income-based benefit in the **unemployment insurance** should be raised.²⁶⁴ The change meant that the average benefit level was raised, which can be assumed to have reduced the incentives to seek employment. The Council's analysis indicated that the change would likely increase the equilibrium unemployment somewhat. However, the Council was still of the opinion that the measure was justified, as the ceilings have remained nominally unchanged since 2002, and the unemployment insurance has therefore provided less and less protection in the event of unemployment.²⁶⁵

²⁶¹ VP15 p. 50.

²⁶² See Arbetsförmedlingen (2017a) p. 126.

²⁶³ BP17.

²⁶⁴ See Spring Fiscal Policy Bill 2015, p. 95.

²⁶⁵ Fiscal Policy Council (2015) p. 99.

The reduced employer contributions for young people have been gradually phased out, and the concession had been removed in full by 1 June 2016.²⁶⁶ This is assessed to have caused a slight decrease in employment.²⁶⁷

The **time limit on the health insurance**, which was introduced by the previous government, was removed on 1 February 2016.²⁶⁸ Furthermore, the sickness benefit and activity compensation were increased from 64.0 to 64.7 per cent of the assumed income as of 1 October 2015. The measures are assessed to have decreased the labour supply somewhat, which means that the equilibrium unemployment is slightly reduced.²⁶⁹

In BP16, the Government proposed a lower **tax for pensioners**, a phase-out of the **earned income allowance**, and a limited upwards adjustment of the limit for **state income tax**.²⁷⁰ The Council's analysis in the 2016 report indicated that the effect of the higher marginal tax on working hours was a decrease of a little over 3,000 full-time equivalents. This can be considered a small change, but it nonetheless has a large impact on the tax revenue.²⁷¹ BP18 included a further tax relief for pensioners in the form of an increase in the basic deduction.

The possibility of receiving **part-time compensation from the unemployment insurance** is intended as a support for people who work part time, but who are able and willing to work full time, in their search for a full-time position.²⁷² BP17 reinforced the

²⁶⁶ A proposal to remove the time limit in the health insurance was included in VP15, see VP15 p. 41. The Government returned to the Riksdag with a proposal in BP16.

²⁶⁷ When the reduction was introduced, IFAU estimated that it could create between 6,000–10,000 jobs in the long term (see Egebark and Kaunitz, 2013). In its 2015 report, the Council made the assessment that it would likely be a smaller number, as the estimation did not take into account any displacement effects (see Swedish Fiscal Policy Council, 2015, s. 94). KI made the assessment that the elimination of the concession would lead to 8,000 fewer people employed (see National Institute of Economic Research, 2015, p. 83).

²⁶⁸ VP15 p. 61.

²⁶⁹ National Institute of Economic Research (2015). The measures were assessed to decrease the labour supply by 0.3 per cent, or just over 15,000 individuals.

²⁷⁰ The increased basic deduction for the elderly was adjusted so that individuals over the age of 65 years would not be taxed at a higher rate than salaried employees younger than 65 years for an income of up to SEK 10,000 per month. The tax was also lowered for elderly individuals with an income of up to SEK 20,000 per month.

²⁷¹ The Council's estimation indicated that the budget reinforcement of the reform decreases from SEK 2.4 to 0.4 billion compared to the statistical calculation, when taking into consideration that the individuals are reducing their labour supply. See Swedish Fiscal Policy Council (2016) p. 57–58.

²⁷² Research in this area indicated mixed results. Some studies find that part-time compensation increases the chances of the individual to find full-time employment, while others conclude the opposite. Ek and Holmlund (2010) compiles a few empiric results on the subject.

unemployment insurance for those with part-time unemployment.²⁷³ This change means that the period with benefits is reduced for those who work more, while those who work less can be granted more days with benefits. This increases the incentives to accept a part-time position, while it reduces the incentives to start working full time. KI made the assessment that the effect on employment was positive but marginal.²⁷⁴

All in all, the Council's assessment is that the total impact on the equilibrium unemployment attributable to changes to taxes and transfers during the term will likely be very small. The change in the health insurance is assessed to have slightly decreased the equilibrium unemployment as the result of a smaller labour force, while the other measures tend to reduce the incentives to work and thereby increase equilibrium unemployment.

²⁷³ See BP17 p. 46–47. The change of this rule means that individuals who are unemployed part-time can receive benefits during a total of 60 weeks, regardless of how many days a week the unemployment benefits relate to.

²⁷⁴ NIER (2016a).

Appendix 2: Capital taxes

A2.1 Calculation of moving tax

Take the example of a house owner in period t . The house was purchased in period 0 for P_0 and its current market value is P_t . The owner is considering selling the house to purchase another house for P_t . If they sell their current house in t , they will incur a capital gains tax of $\alpha(P_t - P_0)$. The alternative is to remain in the original house until T , then sell it and pay a capital gains tax of $\alpha(P_T - P_0)$. If they move, they can choose to pay the tax in t or to have a deferment until T . In the latter case, there is no deductible annual interest rate of 0.5 per cent of the profit $P_t - P_0$. The moving tax is the difference in the discounted present value of tax payments, expressed as a proportion of P_t .

Alternative (1) Not utilising the deferment

The tax is payable at the time of sale, t . The tax payment is financed by a one-year bank loan with interest (before taxes) rate r . Interest charge (after interest deduction) is then $0,7r * 0,22(P_t - P_0)$.

Tax if the household moves:

$$\alpha \left[(P_t - P_0) + \frac{P_T - P_t}{(1 + r)^{T-t}} \right]$$

Tax if the household stays:

$$\alpha \frac{P_T - P_0}{(1 + r)^{T-t}}$$

Difference (“moving tax”):

$$\alpha(P_t - P_0) \left[1 - \frac{1}{(1 + r)^{T-t}} \right]$$

Figure 6.4 expresses this difference as a proportion of the selling price (P_t) for the time period 2008–2017; the holding periods ($t - 0$) 5, 10 and 20 years; $T = 20$ years; and the applicable mortgage rate after interest (r) at each given time t .

Alternative (2) Utilising the deferment

The tax is deferred at an annual deferral rate equal to $0,005(P_t - P_0)$

Tax if the household moves:

$$0,005(P_t - P_0) \left[\frac{1}{1+r} + \frac{1}{(1+r)^2} + \dots + \frac{1}{(1+r)^{(T-t)}} \right] \\ + \alpha(P_T - P_0) \frac{1}{(1+r)^{(T-t)}}$$

Tax if the household stays:

$$\alpha \frac{P_T - P_0}{(1+r)^{T-t}}$$

Difference (“moving tax”):

$$0,005(P_t - P_0) \left[\frac{1}{1+r} + \frac{1}{(1+r)^2} + \dots + \frac{1}{(1+r)^{(T-t)}} \right].$$

Alternative (2) is preferable as long as the mortgage rate r is such that

$$0,005(P_t - P_0) < 0,7r * 0,22(P_t - P_0)$$

i.e. if

$$r < r^* = \frac{0,005}{0,7 * 0,22} = 3,25\%$$

A2.2 Investment savings accounts

We compare two ways of taxing shares: regular income taxation, which is proportional to the actual return *ex post* and a wealth tax (ISK) on a multiple of the market value.

Conventional income tax

The individual is holding the share x of their wealth in secure assets with the return r and the rest, $1 - x$, in risky assets (shares) with the return \tilde{p} , expected value \bar{p} and standard deviation σ . The realised return is taxed at the rate θ . The expected return R per SEK of the wealth is then

$$E(R) = (1 - \theta)[xr + (1 - x)\bar{p}]$$

with the standard deviation.

$$STD(R) = (1 - \theta)(1 - x)\sigma$$

By choosing the portfolio share x , the individual can weigh the risk against the return in accordance with the capital market line (CML), which is given by the calculation

$$E(R) = (1 - \theta)r + \frac{\bar{p} - r}{\sigma} STD(R).$$

The tax thereby creates a downwards parallel shift of the CML. The central government takes a share θ of the secure return r , but the reward for the risk is not affected by the tax.

Wealth tax (ISK)

In this case, the tax is levied as a proportion τ of the secure return r (equivalent to the proportion τr of the wealth). For the individual, the return and standard deviation are now given as

$$E(R) = xr + (1 - x)\bar{p} - \tau r$$

$$STD(R) = (1 - x)\sigma$$

CML is now given as

$$E(R) = (1 - \tau)r + \frac{\bar{\rho} - r}{\sigma} STD(R).$$

The CML for the wealth tax is thus identical to the CML for income tax, given that the tax rates are the same ($\tau = \theta$). The reward for the risk is once again independent of the tax. For the given value of x , the standard deviation is greater than for the income tax, but as the CML is the same, the individual can choose another x in order to have the same expected return and variance as for the income tax.

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