Summary

In recent years, there have been several disruptive changes in economic developments. From pandemic to recovery and on to a high-inflation environment since Russia's full-scale invasion of Ukraine in February 2022, monetary policy tightened, inflation fell back and economic activity weakened.

From having been very active, with large temporary supports during the pandemic 2020-2021, fiscal policy in 2023-2024 has been relatively restrained, with reference to high inflation. Fiscal policy has nevertheless been in the focus of the debate over the past year as the parliamentary review of the fiscal framework has been launched. The review is mainly about the level of the surplus target and the debt anchor, but also about the interaction between fiscal and monetary policy. The Council has submitted a letter to the parliamentary committee in which we describe the principles that should guide the framework review.[1] This issue is therefore not analysed in this year's report.

In addition to an assessment of the government's macroeconomic and fiscal forecasts, the report covers three main policy areas.

Fiscal policy. We analyse the government's fiscal policy in relation to the fiscal framework (chapter 2), look in more detail at the finances of municipalities and regions and discuss the role of central government in financing them in the current strained economic situation (chapter 3).

Labour market and employment policies. We analyse the main reasons why there are people of working age out of work (chapter 4), how the government is tackling this problem and where more effort may be needed (chapter 5).

Climate policy. We describe the various roles that the state needs to play in order for the climate transition to be effective, accepted and sustainable (chapter section 6). Particular emphasis is placed on the importance of political leadership and compensatorial measures to support those who need it most without jeopardising the transition.

Chapter 1 The macroeconomic situation

[1] The letter is available on the Council's website, fpr.se. The Council also published a special study in February on the development of economic inequality in Sweden. This is also available on our website.

Economic growth is noticeably weaker in Sweden and Europe than in the United States. One explanation for this is that fiscal and monetary policy has been more restrictive on our side of the Atlantic. Fiscal policy in particular differs; the United States has pursued a very expansionary policy with large deficits with the risks this entails for public finances in the longer term. Inflation has fallen back rapidly in all three economies , albeit less in the US, and forecasters believe that the central banks will cut key interest rates several times this year.

GDP in Sweden has been virtually unchanged since the end of 2021. Then resource utilisation was higher than normal, which is one explanation for the weak development in recent years. In addition, the relatively weak development in Europe and the Riksbank's interest rate increases have contributed to holding back demand. In 2022 and the first half of 2023, the proportion of companies that retained their employees increased despite weak demand, which can be interpreted as an expectation that the economy would soon pick up again. In the second half of 2023, however, the number of redundancies and bankruptcies rose, resulting in higher unemployment. Both the government and the NIER expect unemployment to continue to rise in 2024. At the same time, the employment rate exceeds the level in 2021-2022, when resource utilisation was higher than normal.

There is no shortage of uncertainties. Russia's full-scale war of aggression in Ukraine has major repercussions for our defence policy, including the supply of weapons, equipment and money. There is also a risk that the war will spread to other parts of Europe. Developments in Ukraine and Gaza, including the intensified conflict between Israel and Iran, may affect inflation via commodity markets and developments in the transport sector.

Chapter 2 The fiscal framework

Fiscal policy in BP24 and VP24 is in line with the budgetary targets and the fiscal framework. The expenditure ceiling is met by a good margin and the debt anchor is within the tolerance interval. In VP24, however, there is a deviation from the surplus target; structural net lending below the target level rises by 0.5 percentage points this year, but as we will return to, this can be justified by the current recession.

In BP24, the Government expected the recession to deepen and inflation to reach the target in the course of 2024. However, at the time of the decision, inflation was still high and the Riksbank continued to

raise the policy rate to 4 percent at its meeting in September. As in BP23, the Government attached great importance in BP24 to not making it more difficult for the Riksbank to combat inflation. The government therefore opted for an almost neutral fiscal policy stance despite forecasts of rising unemployment. Like the Government, the Council considers that consideration of inflation was important in the situation prevailing when BP24 was prepared. The scope of the Government's measures in BP24, totalling SEK 40 billion, was therefore reasonable, even if a slightly more expansionary stance would probably have been possible without the need for further interest rate increases. An appropriate measure in that case would have been higher central government grants to regions, which was later proposed in VP24.

As in last year's report, the Council notes that major measures to influence the structure of the economy for the better are conspicuous by their absence. The areas highlighted by the Council in several contexts are the housing market and the tax system. Other areas where the challenges are major and of a structural nature are schools, health care and care for the elderly.

The Council remains critical of the way in which the Government has implemented its change of method for calculating structural net lending. Structural net lending is the most important indicator for monitoring the surplus target and the requirements for method, documentation and clarity should therefore be high. The current situation, in which the Government and the National Institute for Economic Research use different methods, makes it considerably more difficult to scrutinise the Government's fiscal policy. The issue is therefore essential, even if it is technical in nature. In the previous annual report, we called on the government to produce an impact assessment, but this has not been done. If the government chooses to retain its current methodology, it will need to adapt its analytical framework for what is appropriate fiscal policy from a stabilisation policy perspective and produce an impact assessment.

Chapter 3 Local and regional government finances

The high inflation in 2022 and 2023 means that the pension liability has been substantially revalued in 2023 and 2024 in municipalities and regions. The increased pension liability temporarily weakens the result and makes it more difficult for municipalities and regions to meet the

balance requirement. However, it is possible to deviate from the balance requirement if there are exceptional reasons. We believe that the situation that arose constituted such a reason. However, some municipalities and regions may have interpreted the situation differently and, as a consequence, see implemented temporary reductions or tax increases in order to fulfil the balance requirement. From this perspective, it would have been appropriate for the government to state its view on the use of exceptional reasons. However, whether the Government should do this is unclear from a constitutional perspective. The current handling of the issue is not optimal and how the Government should act in similar situations in the future needs to be considered further.

Even in a longer-term perspective, there are municipalities and regions that have financial problems, but this is far from the case for all. It has been suggested in the debate that one reason for the problems is that central government grants have lagged behind cost developments in the local government sector and should therefore be indexed. Our analysis shows that central government grants have kept pace with the development of rising prices, wages and changing demographics. We are not convinced that central government grants need to be indexed. They have not been eroded over time and indexation would still require annual decisions as factors affecting local government finances, beyond those covered by indexation, vary from year to year. In addition, there is value in annually weighing the level of government grants against other public expenditure. It is clear, however, that the current system entails planning difficulties for municipalities and regions as decisions on central government grants are made late. The Government should therefore investigate the possibilities of making it easier for municipalities and regions by providing information on central government grants earlier than at present, as in Norway, for example.

There is also a discussion that automatic variations in government grants could play a greater role in stabilisation policy. We do not reject such a possibility but believe that such changes should be part of a broader analysis of the use of automatic stabilisers.

The Council believes that the government needs to be clearer in its reporting of the finances of the municipalities and regions. Improvements are needed on three levels. The forecasts of the result need to be reported broken down by municipalities and regions.

Furthermore, the items that explain the difference between the result and net lending need to be reported. Finally, it needs to be shown whether a contribution to municipalities and regions represents a real change or merely covers increased costs and changed tasks. Overall, the current reporting means that it is not possible to reasonably analyse the basis on which the Government has determined the scope of central government grants.

Chapter 4 The Swedish labour market

The Swedish labour market is characterised by a high level of employment and development has been strong over the last 15 years, especially among non-European born. Groups that have difficulty gaining a foothold in the labour market participate in the labour force to a greater extent than in other countries, which is fundamentally positive. At the same time, however, it contributes to higher unemployment than in countries where fewer people are available to the labour market.

Unemployment has become increasingly concentrated to groups labelled as vulnerable by the Employment Agency. We estimate that in 2022 there were around half a million people who were permanently out of work despite being able to work. Three problems are commonly cited to explain such persistent exclusion: weak economic incentives to work, mismatches between employers' needs and unemployed people's skills, and insufficient productivity among certain groups of jobseekers.

The economic incentives to take up work have increased considerably in recent decades and, in our judgement, a lack of incentives is therefore not the main reason why people do not work. A mismatch between the needs of employers and the skills of the unemployed appears to be a more important explanation for unemployment among uncompetitive groups. This is particularly true with regard to education, as jobseekers often lack the specific skills that employers are looking for, for example in healthcare, IT and pedagogy. The matching problem also has less to do with the fact that the jobs and the unemployed are located in different parts of the country.

We also recognise that there are problems with more general skills. Some individuals do not have - or are not considered to have - a pro ductivity that is sufficient to get even simple jobs at the lowest wages

under the collective agreements. In the restaurant and customer service sectors, for example, there is no clear correlation between the number of job vacancies and the number of job seekers with a weak labour market position. To what extent this is because these groups are *actually* not sufficiently productive, or due to the fact that their productivity *is misjudged* by employers due to lack of information or discrimination, is difficult to discern. The reality is likely to contain elements of both lack of productivity and lack of information.

Chapter 5 Measures for more people in work

Our assessment is thus that the economic incentives to work are strong for the vast majority. We are therefore sceptical that earned income tax credits that benefit everyone will have any significant employment effects. Even if the Government's estimated employment effects for the job tax credit in BP24 are small, they are probably an overestimate. To further strengthen the financial incentives to work, the government has also announced that the multi-child supplement will be reviewed and that a benefit ceiling will be introduced. Since financial assistance, unlike the multi-child supplement, is offset against earned income, abolishing the multi-child supplement would not strengthen but rather weaken the economic benefits of taking a job for welfare households with children. Furthermore, a reduction in the level of financial assistance would have to be fairly extensive in order to clearly strengthen incentives where they are weak, mainly among families with children where only one parent is available to the labour market. At the same time, such a change would affect the standard of living of all recipients and imply a reassessment of the adequate standard of living. A more feasible route would be to reduce the offset of financial assistance against labour income. Such a reform would likely have positive, but small, effects on employment.

The focus should instead be on improving matching and mitigating the problems of poor productivity and information. The matching problem can be counteracted by increasing the number of unemployed in upper secondary vocational education. The number of participants in labour market training therefore needs to increase, which should be achieved through a number of changes in the governance of the Public Employment Service; labour market training should also be provided in areas where Komvux operates, there should be greater flexibility in appropriations and procurement processes should be reviewed.

The problem of lack of productivity and information can be countered by employers bearing less risk, for example by introducing the possibility of probationary employment for one of the existing employment subsidies or by the government taking on employer responsibility during an initial phase. Subsidised employment has the potential to increase in scope if it is supplemented with intensive placement measures, such as *Matching from Day 1*. The Government should direct the employment agency to introduce this type of job placement permanently in its operations.

In general, labour market and employment policies need to be better at translating research results and proven experience into actual action.

Chapter 6 Government roles in the climate transition

To slow down global warming, greenhouse gas emissions must be curbed. This will require a major transformation of the economy and will inevitably have an impact on individual households and businesses. Governments have several important roles to play in making the climate transition effective, accepted and sustainable.

We are critical of the government's climate policy on several points. Most fundamentally, the government lacks a coherent and comprehensible strategy for achieving both the Swedish and EU climate targets by 2030. Measures have been taken that in themselves increase emissions while emission reductions are postponed. This, together with optimistic hopes of being able to buy emission allowances from other countries and the lack of sufficient measures to increase the uptake of carbon dioxide in forests and soil, risks that the climate targets will either not be met or will be expensive to fulfil.

A coherent strategy is also needed to enable households and businesses to make timely and informed investment decisions and thereby make the transition in a cost-effective way. A clear roadmap is particularly important for households with smaller financial margins and who are more affected by the climate transition. Due to the government's policies, emissions need to be reduced very rapidly by the end of the 2020s and there is a high risk that those most affected by the instruments required by then will not have adapted.

The climate transition will entail a financial burden in the short term for many households. This applies in particular to the transition to a fossil-free vehicle fleet and to higher fuel and electricity prices, but the

EU directive on energy efficiency will also entail costs. The government's climate action plan promises that houses and businesses will not be negatively affected by the climate transition, including a promise that *everyone* will be fully compensated for higher fuel prices. This is neither reasonable nor feasible. This type of promise may also constitute an obstacle to the transition and risks becoming a source of dissatisfaction when the promise proves impossible to fulfil. If you want to compensate households for higher fuel prices aimed at reducing emissions, you cannot, of course, lower the price, as this is completely contrary to the very purpose of higher prices. Rather, one should use compensation mechanisms that affect the incentives to reduce emissions, as little as possible.

The Council believes that the Government should specifically examine the possibilities for various forms of so-called local compensation, particularly with a view to reducing the differences in how the transition affects urban and rural areas. For example, government revenue from carbon tax could be used to support households in sparsely populated areas. Targeted support can be generous without entailing large public finance costs. Furthermore, municipalities should be given economic incentives to favour the expansion of wind power, for example through a municipal property tax on wind power or by allocating part of the profits from wind power to the municipality.

The climate transition is necessary. If it is to work well, it requires broad public acceptance. Studies show that attitudes to climate measures can be influenced by information about the effectiveness of the measures, the distributional effects and the impact on the economy. The state needs to show leadership in the transition; climate policy needs to be clarified and defended - in order to achieve acceptance of the necessary sacrifices.

Chapter 7 Forecast evaluation

Government forecasts of economic developments are important to ensure that fiscal policy does not become pro-cyclical and amplify economic fluctuations. There are international examples where governments' forecasts systematically have been too optimistic. This is one reason why fiscal policy councils in the EU have a scrutinising role in this area.

Based on NIER's evaluations, we find that there are no systematic errors in the government's forecasts for GDP growth, unemployment, the policy rate or net lending. We also find that the government's forecasts are as accurate as those of NIER and the Riksbank for the next year. On the other hand, NIER has a significantly higher accuracy than the Government when it comes to GDP growth, unemployment and net lending for the current year. The Council believes that the Government should investigate the reasons for this.

Structural net lending is the most important indicator of whether fiscal policy is in line with the surplus target. It is therefore important to know how uncertain the assessment of this variable is. Structural net lending depends on unobservable variables such as potential GDP and there is no outcome to compare with. We therefore compare with the latest assessment of this variable to estimate the forecast uncertainty. Our conclusion is that the uncertainty in the Government's forecasts for structural net lending is in line with NIER's and that it remains reasonable to regard a deviation from the surplus target as clear if structural net lending deviates by more than 0.5 percent units from the target level.

Our analysis also shows that the forecast errors for structural net lending are greater when the economic situation changes substantially. This is probably because changes in GDP to some extent affect the assessment of potential GDP in the same direction. As structural net lending varies positively with potential GDP, an improved GDP gap will on average mean improved structural net lending and vice versa. This is good news as it means that fiscal policy will change in a counter cyclical direction when assessments of the economic situation are revised.