Summary

Russia's assault on Ukraine has brought inconceivable suffering upon Ukrainian people, as well as extensive capital destruction in one of Europe's largest countries. The war has upended the European security order and impacts economic developments, not just in Europe, but across the globe. The immediate effects – refugees, boosts to defence expenditure and rapid price increases on certain goods – may in hindsight appear less significant in contrast to the cumulative consequences of the war, both regarding security policy and trade.

The war in Ukraine has already had long-term implications for Sweden's public finances, as a political consensus has been reached to gradually increase defence expenditure to 2 percent of GDP. That adds to an eventful year for Swedish fiscal policy, which has seen several extensive measures be undertaken in areas such as pensions, public health insurance, and compensation to households for high energy prices. Moreover, the Swedish Climate Policy Council and Swedish National Expert Council for Climate Adaptation have argued for increased efforts to reduce carbon emissions and prepare society for the climate changes that await. Many expenditure-increasing measures have been proposed and voices have been raised to change the fiscal framework before the scheduled review.

This year's report in divided into five chapters and considers fiscal policy developments over the past year and the challenges that lay ahead. The pages that follow give a summary of the chapters and the Council's conclusions.[1]

Chapter 1, Developments in the economy

The economic recovery in Sweden has been strong since the pandemic wore off. An extensive vaccination campaign has been decisive for the positive development; however, economic policy has also played an important role. The massive fiscal support measures which were introduced were generally well-designed and have mitigated the pandemic's economic consequences for individuals, businesses and municipalities. In addition, the measures have likely contributed to businesses being capable of meeting the surge in demand for goods

[1] We would also like to highlight the Council's study on the pension system and incomes of pensioners, which we published on 6 May this year. A summary in English is available on the Council's website.

and services after the pandemic. In the business sector, the recovery has been particularly strong in the areas which were hit the hardest by the necessity of social distancing, and thus far there are few signs that the pandemic will result in any larger changes to the structure of the economy. The labour market has evolved more positively than expected, employment has increased sharply, and the recovery has been especially strong among young workers. However, the situation among those with low education is more worrying, and particularly among foreign born without an upper-secondary school degree. They were badly affected by the pandemic, and the group's unemployment rate remains sharply elevated. It is crucial that measures are taken to address this problem.

Prior to the war breaking out, the global economic recovery was characterised by uncertainty over how the pandemic would evolve; vaccination rates are low in many developing countries and the risk of new mutations of the virus was present. The war in Ukraine means that the uncertainty around short-term economic developments has risen markedly. The war has already weakened growth prospects and contributed to increased risks in the world economy. In April, the IMF lowered its forecast for global trade and growth for 2022 och 2023.

Increased inflation poses a significant risk going forward. Inflation had risen to its highest level in decades even before the war, as a combined result of the strong recovery and various supply disruptions. Further price increases on raw materials and groceries in the wake of the war has induced many central banks to sharpen their tone and, in some cases, to make monetary policy adjustments. The Riksbank raised the repo rate from 0 to 0,25 percent at the end of April, and it forecasts further increases to 1,5 percent by the end of next year. Higher interest rates will impact countries with high debt levels, whether the debt is public or, as in Sweden, mainly private. Asset price declines cannot be ruled out, which may cause concern in financial markets and reverberations across the real economy.

Taken together, the uncertain situation means that the public sector must be prepared for contingencies, and that Sweden's strong fiscal position is an asset.

Chapter 2, The fiscal framework

In relation to the economic forecasts which constituted the basis for policy in the Budget Bill of 2022 and Economic Spring Bill of 2022, the scope of unfinanced measures is too large. That includes the budget proposal of the opposition, which won the vote in parliament. Although the economy was deemed to be at potential in 2022, the government and parliament chose to deviate from the surplus target by nearly one percentage point. The government motivates the deviation by referencing stabilisation policy needs and an ambition to increase employment. The government's motivation does not persuade. First and foremost, the government's own forecast indicates that the economy is above potential. Secondly, structural reforms to increase employment or targeted measures to alleviate the situation among foreign born and people without upper-secondary school degrees, could have been enacted without exceeding the limits of the surplus target.

According to the fiscal framework, the budgeting margin in the spring bill should be at least 1,5 percent of the capped expenditure for the upcoming year, which corresponds to around 23 billion SEK for 2023. In the spring bill, it is instead estimated that the expenditure ceiling will be exceeded by about 7 billion SEK. In other words, the deviation from the guidelines amounts to 30 billion SEK. The budgeting margin continues to be too low in 2024. As such, economic policy deviates from the framework's guidelines in relation to the expenditure ceiling in both 2023 and 2024. If there is a risk that the expenditure ceiling is breached, the budget law stipulates that the government either takes measures, or propose suitable measures to the Riksdag, to prevent that from happening. The government chooses not to do so with reference to prevailing uncertainties. Contrary to the government's position, the Council views uncertainty as grounds for caution with taking on new expenditure. It is stated in the spring bill that the government will get back to the parliament with a proposal for expenditure-limiting measures in connection with the budget bill in the autumn. The Council believes that the government should have discussed the extent of such measures, including which prioritisations might come into question, in the spring bill's guidelines for economic policy.

As noted in last year's report, there are worrying signs that the unitary budget process is being eroded. Developments over the past year have reinforced this concern. The unitary budget process is a central element of the fiscal framework; it creates conditions for a structured analysis of different proposals and contributes to clarifying political priorities. To maintain a unitary budget process, proposals with sustained budgetary effects should be made in the budget bill, and changes to the current budget are normally proposed twice a year, in connection to the budget bill and spring bill. The sustained increase in defence expenditure, the rapid decision on which was necessitated by changing geopolitical circumstances, can be viewed as a reasonable exception to the rule. However, the "garantitillägg", a monthly grant of up to 1 000 SEK to one million pensioners, should have been handled within the regular process.

Large scale proposals to increase expenditure have recently been handled outside of the ordinary budget process, and extensive measures have been taken without being financed. In last year's report, the Council was generally positive to the policies which were introduced to alleviate the economic consequences of the pandemic. We were simultaneously concerned that the budget process was being weakened, and developments since then have strengthened that concern. It is important that the process is normalised and that the possibilities to change the budget, whether it be through bills or committee initiatives, are used conservatively. A fragmented budget process risks becoming a weak budget process, with an insufficiently holistic view and a lack of prioritisation.

Chapter 3, Labour market and public finances in the long term

In recent decades, Sweden's public debt ratio has been greatly reduced. Rising employment among older workers is an important part of the explanation for this positive development. Various measures which may affect the employment rate in older age groups have recently been adopted and announced.

The Council is positive to the introduction of a "riktålder" in the pensions system because it will raise the minimum age of eligibility for public and guarantee pension. This will likely contribute to a higher rate of employment among older workers. However, the magnitude of this effect is uncertain. There still exists a strong norm to retire at the age of 65, and age discrimination in the labour market continues to inhibit the extension of working life. There is a risk that such problems will mitigate the riktålder's effect on employment among older workers. If the average age of exiting the labour market rises by 0,5 years less in the coming two decades than expected in the NIER's base scenario, we estimate that public debt will rise by 5 percent of GDP over the corresponding time period.

Several changes to the public health insurance system have been announced and implemented, some of which will increase the number of persons who are granted sick leave and sickness benefits. Among other things, this pertains to the so called "trygghetspension". Based on prior experience of similar changes, there is a risk that the announced reforms, all of which imply a relaxation of labour capability evaluation standards, have considerable negative effects on employment. A design of the sickness benefit system whereby the capability of older workers is evaluated against a more limited segment of the labour market appears especially significant in this regard. Based on historical experience, employment may diminish by 120 000 persons in the coming twenty years. In such a scenario, public debt could increase by as much as 15 percent of GDP.

Both these calculations, on the importance of the riktålder and the changes in the public health insurance system, illustrate the significance of employment to public finances. When announcing reforms which may have a negative impact on employment, it is crucial to consider the extensive empirical experience that exists, and to work with reasonable assumptions and safety margins. Otherwise, there is a great risk that other important public commitments are crowded out. Reforms of this kind should regularly be evaluated and complemented with policies in other areas which promote a longer working life.

Chapter 4, Climate measures – the need for public financing

If the Riksdag's objectives for climate policy are to be achieved, the pace of climate transition must be accelerated. Against this background, arguments have been put forward to revise the fiscal framework earlier than planned, the purpose being to create fiscal space for credit financed climate measures. To form a well-founded opinion on the merit of these arguments, it is necessary to closely consider the extent of the public commitments which may become necessary over the coming years. Oddly enough, no comprehensive investigations have been made.

If the current climate targets are treated as given, such an investigation would need to be based on an analysis of how well the targets are met, to what extent public interventions are needed and whether these interventions should be financed through higher debt, higher taxes or lower expenditure in other areas. The Swedish Fiscal Policy Council does not have the resources to conduct such an investigation which, in addition to its extent, would require political considerations to be made. In approaching the issue, we have therefore chosen a narrower perspective which departs from assessments made by public investigations, authorities and other actors. The point of departure for these assessments are assumed to be that Sweden meets the Riksdag's target of net carbon neutrality by 2045.

Our review suggests that large scale climate-related investments will indeed be necessary over the coming decades, especially to ramp up electricity production and expand the transmission network. However, the lion's share of these investments will most likely be financed by businesses and households. The reports we have reviewed generally do not describe public financing as the main bottleneck for cutting emissions. Rather, it is streamlining of authorisation processes, stable and clear rules, and national coordination which are needed. An exception is financing of charging infrastructure for electric vehicles and hydrogen refuelling stations, which need to be financed by public means in areas where market solutions are not realistic. Another exception is investments in so called biogenetic carbon capture and storage systems. We identify several knowledge gaps with respect to the necessity of public financing in the green transition, the most important of which pertains to the need for measures to adapt society to the climate changes that lay ahead.

Taken together, existing accounts suggest that the need for publicly financed measures sums to 25–45 billion SEK per year over the coming decades. These numbers encompass efforts to cut emissions, prepare society for the coming climate changes and provide aid in the event of extreme weather disasters. That is in addition to the planned climate-related investments which make up the current twelve-year infrastructure plan, and which sum to about 60 billion SEK per year in today's prices. The uncertainty, however, is considerable.

Chapter 5, Should the framework be reviewed?

The fiscal framework was revised in 2019 based on the recommendations of a parliamentary committee from 2016. During the revision, it was also decided that further reviews should be conducted every eight years. The chosen interval of eight years was the result of a trade-off between different factors. In the interest of stability and predictability, the framework should not be changed too often. A framework which is frequently altered loses in strength and credibility and becomes difficult to evaluate. On the other hand, a framework which is never revised, even when circumstances change substantially, risks losing legitimacy and fading into irrelevance over time.

A number of arguments have been put forward to change the framework before the scheduled review. That would imply a deviation from the agreed upon order of conducting a review every eight years. The threshold for changing the framework in advance ought to be higher than for changes within the boundaries of the existing order. Nevertheless, altering the framework before time should not be ruled out if new and relevant information comes to light.

The arguments in favour of changing the framework can be divided into four categories: the framework limits the contribution of fiscal policy to macroeconomic stabilisation; it has constituted a drag on public investment; it disregards the low interest rate environment; and it takes no notice of the need for additional resources to public sector commitments.

The Council's assessment is that the framework has neither hampered the effectiveness of stabilisation policy, nor lowered public investment. Interest rates are still low by historical standards, which may constitute an argument for higher debt levels. However, government bond yields have increased markedly in the last year, and do not differ meaningfully from the yields which prevailed when the decision on the previous framework change was taken in the autumn of 2017. Moreover, steadily increasing private debt levels in Sweden, increased public debt abroad and the deteriorating geopolitical situation underlines the importance of strong public finances. Moreover, the framework does not stand in the way of a sustained increase in ambitions within the public sector. A greater commitment in the area of public welfare should, however, be financed by either higher taxes or through prioritisation with existing means.

There is extensive support for increasing defence expenditure to 2 percent of GDP, and the Swedish Armed Forces communicated in April that the target can be reached by 2028. Compared to current levels of defence spending, the new target would correspond to a total increase in expenditure of about 30 billion SEK, or 5 billion SEK per year. In the Council's view, such a comparatively small annual increase in expenditure does not justify an earlier framework revision than planned. However, the geopolitical situation may change quickly. Should a considerably faster and more extensive increase in defence spending be required, a temporary deviation from the surplus target may be preferrable to a change in the framework.

The strongest argument for an early revision relates to the possible need of public financing in the climate transition. The argument's strength derives from the temporary nature of the expenditure increase; it appears that especially large efforts will be required in the coming two decades. Moreover, the needed measures can be viewed as investments. There is an apparent risk that the scale of these investments becomes smaller than desirable if the present generation alone must finance them. It is also relevant that the climate transition was not taken into consideration when the parliamentary committee reviewed the framework in 2016.

Our overview in chapter 4 suggests that the need for public financing is not as great as many seem to imagine. However, the uncertainty is considerable and knowledge is lacking in many areas. In addition, the severity of the world's climate predicament has become clearer in recent years. The Council does not view a revision of the framework as motivated at this time. Nevertheless, there are strong reasons to comprehensively analyse the climate challenges that Sweden faces, and how they can be dealt with in an appropriate and effective manner. Depending on the findings of such an analysis, it is possible that the framework would need to be revised earlier than planned.

Finally, compliance is imperative if the fiscal framework is to function. A prerequisite for the framework's credibility is that it enjoys broad political support; indeed, its political embeddedness is more important than the exact design of the rules. In the Council's view, it is therefore of great significance that changes to the fiscal rules are passed in broad political accord.