Summary

In recent decades, the responsibility for stabilisation policy has mainly fallen to monetary policy, while fiscal policy's role has primarily been seen as serving the functioning of the economy and ensuring the sustainability of public finances. The role of fiscal policy in stabilisation policy has mainly been limited to contributing via the automatic stabilisers, except in deep crises when fiscal policy has contributed to cyclical stabilisation with active fiscal measures. The current fiscal policy framework is mainly a budgetary policy framework aimed at ensuring the sustainability and transparency of fiscal policy in the long term.

The sharp division between fiscal and monetary responsibilities for stabilisation policy was first put into question after the global financial crisis, and this debate has intensified since the pandemic. These crises clearly demonstrated the difficulties faced by monetary policy in addressing cyclical stabilisation. One important reason for this is the decline in the neutral real interest rate in recent decades, which has diminished the Riksbank's ability to use the policy rate to stimulate the economy as necessary. In response to this, the Riksbank has expanded its monetary policy tool kit with measures such as extensive quantitative easing, which has incurred large costs for the Riksbank, and by extension, public finances.

Raising of the inflation target from 2 to 3 percent would increase conventional monetary policy space, but the increase should be made in unison with other central banks. A change that is easier to implement is a transition to average inflation targeting. Relaxing macro-prudential regulation could also support stabilisation of the economy during a severe recession. However, such changes are very likely only a partial solution, and fiscal policy will likely need to assume greater responsibility for stabilisation policy in the future. At the same time, views regarding fiscal stabilisation policy have

grown more positive as the impact of fiscal stabilisation policy on the economy has proven to be greater than previously thought. The rapid response to the pandemic also demonstrated that measures could be adopted quicker than expected.

Effective stabilisation policy is characterised by swiftness, efficiency and impermanence. Should fiscal policy assume responsibility for stabilisation policy, it would be advantageous to establish a framework for fiscal stabilisation policy that supplements the current fiscal policy framework.

A framework for fiscal stabilisation policy should specify what fiscal policy is expected to stabilise, when this will occur, and which fiscal policy instruments that are to be used to achieve the target. The stabilisation policy pursued can be made more credible by establishing a new board, tasked with generating decision guidance and forward-looking recommendations to the Government, partly to introduce a limit on the size of the fiscal stabilisation policy, partly to require the Government to provide detailed information about its fiscal stabilisation policy in extra amendment budgets, and partly to strengthen the Riksdag's review of fiscal policy by placing the Fiscal Policy Council as a function under the Riksdag.

A greater focus on fiscal stabilisation policy means that certain budget rules may need to be adjusted and supplemented. To underline the importance of long-term sustainable finances, which are necessary for the effectiveness of active fiscal policy, the balance target for the upcoming framework period could be anchored in an assessment of an appropriate long-term level for the gross debt. Active stabilisation policy conducted changing expenditures can be added within a new expenditure area outside the expenditure ceiling to further speed up the stabilisation policy decision-making process.

In order to ensure a quick and approppropriate fiscal stabilisation of the business cycle, extra amending budgets can mainly be used to carry out the fiscal stabilisation of the business cycle. In addition, there may be reasons to review the budget process to ensure that structural and stabilisation policy bills receive broad support in the Riksdag. This can be done by, for example, updating the arrangement for political negotiations between the Government and the parliamentary parties in the Committee on Finance.

Stabilisation policy in recent decades

The aim of stabilisation policy is to diminish fluctuations in output, employment and inflation over the business cycle in order to reduce welfare losses. A prolonged period of high unemployment can have negative persistence effects on employment. However, it is not only the threat of recessions that must be addressed. Even boom periods can be costly in terms of misallocated resources across the economy and accumulated imbalances that can later precipitate unfavourable economic developments.

Effective stabilisation policy is characterised by swiftness, efficiency and impermanence. To that end, instruments of stabilisation policy should: during the same period as the disturbances that they are intended to counteract; be adapted to the nature and size of those disturbances; and be withdrawn as soon as they are no longer needed.

In a floating exchange rate regime, monetary policy is usually considered more effective than fiscal policy in stabilising the economy. Many advanced economies, including Sweden, now has a floating exchange rate. In recent decades, independent central banks in these economies, the Riksbank of Sweden included, have thus been given principal responsibility for stabilisation policy. The central banks have used the instruments of monetary policy at their disposal. At the same time, fiscal policy's role has been considered to improve the functioning of the economy through structural reforms, while also ensuring the sustainability of public finances. The role of fiscal policy when it comes to stabilisation policy has mainly been limited to contributing via the automatic stabilisers, i.e. that taxes and public expenditure naturally vary with activity in the economy and are thus ”automatically” adapted to the economic development in such a way that the economy stabilizes.

The macro-economic conditions have changed in recent decades

The difference between the level of the neutral interest rate and economic growth, the so-called interest-growth differential, has fallen sharply over the past 20 or so years. This decline is largely due to a decline in the neutral real interest rate (i.e. the interest rate at which the economy neither expands nor contracts). The average interest-growth differential is expected to remain negative until 2040, after which it is expected to be positive.

There are two main reasons why changes in the interest-growth differential have significance for economic policy. Firstly, the interest-growth differential has an impact on the sustainability of public finances. This is because a permanently low or negative interest-growth differential means that a stable public debt-to-GDP ratio is compatible with lower net lending. For example, a permanent negative interest-growth differential means that a lower surplus target is compatible with sustainable finances, which creates room for lower taxes and/or higher spending.

Secondly, the interest-growth differential has an impact on stabilisation policy. Lower neutral real interest rates entail that central banks must implement lower policy rates to stimulate the economy. This was evident during the global financial crisis and the pandemic, when the policy rates of many central banks hit the so-called lower effective bound, meaning they were unable to lower the policy rates as much as they wanted to stimulate the economy.

The financial crisis and the pandemic demonstrated the limitations of monetary policy, while simultaneously revealing that many alleged shortcomings associated with fiscal policy were less significant than previously believed. The numerous decisions on fiscal stabilisation measures that were taken showed e.g. that the decision-making process can be short. Although in many countries fiscal policy assumed a major responsibility for stabilisation policy in the context of the global financial crisis, it was only after the pandemic that the sharp division of responsibilities between fiscal and monetary policy vis-a-vis stabilisation was seriously questioned.

The monetary policy space can be expanded

Low neutral interest rates, together with the effective lower bound for policy rates, have limited monetary policy's ability to conduct stabilisation policy. To stabilise the business cycle, the Riksbank has i.a. undertaken extensive quantitative easing, entailing great costs for the Riksbank and, by extension, the public finances. An important lesson learned is that there is a potential need to expand the policy space for conventional monetary policy. Various changes to monetary policy strategy may therefore be necessary to avoid overuse of quantitative easing and to ensure that monetary policy retains principal responsibility for stabilising the economy.

Raising the inflation target from 2 to 3 per cent would expand the monetary policy space but would not solve the problem that the effective lower bound for policy rates may still constrain monetary policy. However, a change in the inflation target should be done jointly with other central banks, i.a. as this would likely give credibility to the new target more quickly. Another important reason is that Swedish wage negotiations can be facilitated by an inflation target in line with the rest of Europe.

One change that is more achievable in the short term is the adoption of an average inflation target. This change has already been implemented by the US Federal Reserve. This change may make monetary policy more flexible and effective, but it would not solve the problem that monetary policy space, from time to time, may be limited.

Macroprudential regulation can play a role in stabilisation policy

One lesson of the global financial crisis is that financial stability is a prerequisite for the proper functioning of monetary policy transmission mechanisms. At the same time, the extended period of very low policy rates during the 2010s shows that expansionary monetary policy can also inflate asset values and lead to a large build-up of household and corporate debt, increasing the risk of future financial instability. To increase the resilience of banks, households and businesses, a new area of economic policy has been established – macroprudential policy– with the aim of analysing, monitoring and taking measures to counteract vulnerabilities that risk hindering the financial system's ability to maintain its functions. This is to be achieved through appropriate regulation of banks and other financial institutions and their borrowers (households and non-financial corporations). Macroprudential regulation, with its explicit aim of ensuring sufficient resilience in the private sector and banks, plays an important preventive role.

One often overlooked role of macroprudential regulation is that it can contribute to cyclical stabilisation in crises or severe recessions when the need to strengthen aggregate demand is large. In such situations, easing these regulations can have a significant impact on GDP, employment, and inflation.

One way to clarify the role of macroprudential policy in stabilisation could be to amend this policy area's formulated target. The overarching target of macroprudential policy could then be to safeguard the stability of the financial system as a whole while taking into account any potential side effects that the policy might have on both the functioning of financial markets and fluctuations in the real economy and inflation.

Another way could be to review the decision-making processes. For example, the Financial Supervisory Authority's decision-making process regarding macroprudential regulations (which have a systemic perspective) can be separated from the decisions it takes in the context of its primary responsibility for microprudential supervision (which have a business-level perspective). Such a distinction, between the systemic perspective on the one hand and the business-level perspective on the other, can be achieved by a committee, with the Financial Supervisory Authority as the host authority, being given responsibility for the decisions regarding macroprudetnial supervision.

Fiscal policy needs to take greater responsibility for stabilisation policy

There are five central reasons why fiscal policy ought to assume greater responsibility for stabilisation policy in the future, and thereby support monetary policy in stabilising the economy. The first reason is that the Riksbank's policy rate is expected to, at times, be constrained by the lower effective bound, limiting the ability of monetary policy to stabilise the business cycle.

The second reason is that quantitative easing, which risks creating losses for the Riksbank and ultimately the public finances, is less attractive as a stabilisation tool and is considered less effective than conventional monetary policy.

The third reason is that the understanding of the transmission mechanism of monetary and fiscal policy has changed. Monetary policy's ability to influence the redistribution of household consumption over time is no longer considered to have as central a role for monetary policy to deliver as intended. At the same time, the redistribution of income between households with different marginal propensities to consume is considered to play a relatively important role in the impact of monetary policy on the economy. This means that the transmission mechanisms of monetary and fiscal policy are more similar than previously thought. At the same time, recent research shows that the size of fiscal multipliers, i.e., the extent to which fiscal policy measures affect demand in the economy, is greater than previously estimated. This is particularly true when monetary policy is constrained by its lower effective bound.

The fourth reason is that the automatic stabilisers have become smaller in the past two decades. This suggests that a greater element of active fiscal stabilisation policy is needed since the automatic stabilizers do not support the stabilisation of the economy to the same extent as before. In addition, the supportive role of fiscal policy can be strengthened by trying to strengthen the automatic stabilizers.

The fifth reason is that it seems possible to make fiscal policy decisions more quickly than previously thought possible. During the pandemic, for example, a series of stabilisation measures were taken in a short time.

Supplement the current fiscal policy framework with a framework for fiscal stabilisation policy

The current fiscal policy framework has served the Swedish economy well. It has created stability in the economy, which has been of great benefit, not least in connection with the global financial crisis and during the pandemic. It has also, together with the structural reforms undertaken in the 1990s, contributed to favourable GDP growth and sustainable public finances.

The current framework is mainly a budgetary policy framework aimed at ensuring the sustainability and transparency of fiscal policy in the long term. The framework contains budgetary policy targets and constraints (surplus target and debt anchor for the public sector, expenditure ceilings etc.), rules and practices for the central government budget process, external monitoring and transparency provisions (see figure 1).

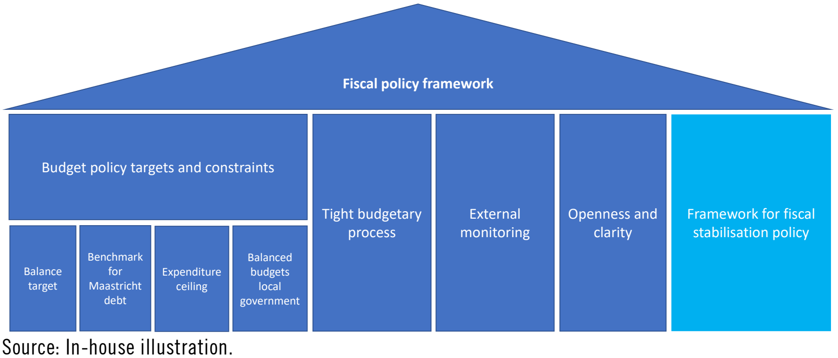
When the current fiscal policy framework was developed in the 1990s, the common assessment was that it would primarily be monetary policy, together with fiscal policy's automatic stabilizers that would take care of business cycle stabilisation. Against this background, it is perhaps not so surprising that the fiscal policy framework at present lacks a supplementary framework for fiscal stabilisation policy.

The absence of a fiscal stabilisation policy framework has not prevented the fiscal policy from conducting stabilisation policy during certain periods, e.g. during the pandemic. This should not be misinterpreted as a sign that a fiscal stabilisation policy framework is not needed. However, it is important to distinguish between stabilisation policies carried out during deep economic crises such as the pandemic, and those carried out in recessions or booms. The current fiscal policy framework lacks goals, strategy, etc. that would enable an effective implementation of fiscal stabilisation policy measures during such periods.

Should fiscal policy assume a larger responsibility for stabilisation policy, it would be advantageous to equip it with a framework for stabilisation policy. This can be done by supplementing the current fiscal policy framework with a framework for fiscal stabilisation policy, while adapting the budgetary target, the budgetary process, and the independent review to the changed circumstances (see figure 1).

A framework for fiscal stabilisation policy would not only provide decision support for the Government and the Riksdag, but it would also reduce uncertainty regarding future stabilisation policy. Less uncertainty facilitates planning by households, businesses and local governments, which in turn can contribute to the increased effectiveness of stabilisation policy. A framework for fiscal stabilisation policy also reduces the risk that adopted temporary fiscal measures will become permanent. Expanding the current framework for fiscal policy to address new economic conditions is one way to ensure that the credibility accumulated for Swedish economic policy and public finances is maintained going forward.

Figure 1 **The fiscal policy framework supplemented by a framework for fiscal stabilisation policy**



Source: In-house illustration.

Central parts of a framework for fiscal stabilisation policy

A framework for fiscal stabilisation policy should clearly specify what fiscal policy is expected to stabilise, when it should stabilise, and which fiscal policy instruments that should be used to achieve the target.

The objectives of stabilisation policy are usually defined in terms of resource utilisation in the economy and the gap between actual inflation from the inflation target. However, an additional important objective of fiscal stabilisation policy is the sustainability of public finances. Fiscal stabilisation should therefore aim to reduce cyclical fluctuations in output and employment while maintaining low and stable inflation, without jeopardising the sustainability of public finances. A target that does not prioritise among different target variables allows for flexibility in handling various economic shocks.

In addition to having a clear target, it is useful to specify different strategies for the response of fiscal policy to various economic shocks and conditions. This is beneficial not only for decisionmakers, but also for different agents in the economy, because it helps them to gain an informed view regarding expected fiscal stabilisation policy.

When economic conditions change because of demand shocks, monetary policy's principal responsibility for stabilisation policy remains as important as under normal economic conditions. In these situations, fiscal policy contributes through the automatic stabilisers. During a recession, boom or at times when the effective lower bound limits the Riksbank's policy rate, fiscal policy can provide support monetary policy mainly through semiautomatic stabilisers, i.e. automatic stabilisers that are activated when an economic indicator exceeds or falls below a trigger point. The same applies during a boom. In a severe recession or boom, the semiautomatic stabilisers can be complemented by discretionary fiscal measures, i.e. a policy that actively changes tax rates and public spending to stabilize the economy.

When the economic situation changes because of supply shocks, fiscal stabilisation policy can be used to support particularly vulnerable groups without allowing the overall fiscal stance becoming expansionary.

There is always a certain degree of fiscal stabilisation through the automatic stabilisers. One example of such an automatic stabiliser is the unemployment insurance. As unemployment increases, the fall in aggregate demand in the economy is dampened by maintaining the consumption of those becoming unemployed. There are several ways to strengthen the automatic stabilisers. One alternative might be to design the rules for government grants to municipalities so that they automatically compensate for cyclical variations in municipal tax revenues. Another alternative might be to provide companies to carry-back tax loses to be offset against tax paid previous years within corporate taxation.

Another way of pursuing fiscal stabilisation is to make active decisions, either discretionarily or semi-automatically. Fiscal stabilisation rules can be used to determine the fiscal scope for active fiscal stabilisation policy, considering the size of the automatic stabilisers. Which fiscal policy instruments to consider can be assessed based on several criteria, such as celerity and efficiency.

One semiautomatic stabiliser worth considering is lumpsum transfers or temporary income tax reductions during a recession, or corresponding income tax increases during booms. Other semiautomatic stabilisers worth consideration includes cyclical unemployment benefits, subsidies for temporary employment, rescue loans/reorientation support, labour market programmes and government grants to municipalities.

If additional fiscal stabilisation is needed during a severe recession, the following discretionary stabilisation measures may be considered in particular: changing government consumption or investment, adjusting taxes and transfers, and/or the tax credit for repair. In case government grants to municipalities do not change automatically or semi-automatically, they could be varied on a discretionary basis to allow municipalities to maintain consumption.

As fiscal policy takes on a greater responsibility for the stabilisation policy in the future, the need for solid analysis and qualified documents for decision-making in this area will increase. To increase the degree of transparency in fiscal policy, there is a particular value of making such analyses publicly available prior to making decisions. This can be achieved by establishing a new board, hosted by the National Institute of Economic Research, which will continually generate decision guidance and in-depth reports as well as providing recommendations to the Government regarding the appropriate stance of fiscal stabilisation policy. It is important to note that this board would only provide analysis and recommendations. The Government and Riksdag are free to adopt whatever decisions they deem appropriate. The Riksdag's authority over fiscal policy remains unchanged.

It is not appropriate for the Fiscal Policy Council, whose principal task is to scrutinize the fiscal policy, to make recommendations regarding the direction of fiscal stabilisation policy. One way to ensure the independence of the new board is to regulate its independence with a dedicated law. Another way is to draft its terms of reference and appropriation directions at a very general level, enabling the board to design its own working arrangements.

Sustainable public finances are a necessary condition for stabilisation policy

Long-term sustainable public finances are a necessary condition for the active fiscal stabilisation policy as well as monetary policy to be effective. To underline the importance of long-term sustainable finances, the balance target for the forthcoming fiscal framework should be formulated in terms of the net lending -to-GDP ratio over a business cycle and be anchored in an assessment of an appropriate long-term gross debt-to-GDP ratio (long-term anchor for Maastricht debt). This assessment needs to consider the need for public expenditure to finance investments related to climate change, as well as the buffer that may be needed to be able to carry out an effective fiscal stabilisation of the business cycle. There exist good reasons to finance such temporary investments with debt. It is not economically efficient to vary tax rates. At the same time, given Sweden's very strong public finances, it is not justified to temporarily reduce the public sector's expenditures to finance these investments.

The Inquiry's analyses indicate that a long-term anchor for Maastricht debt of 40-50 per cent of GDP would be appropriate given these criteria. This debt level is higher than at present, but Sweden would remain a country with sustainable public finances and with low debt levels by international comparison.

In the medium term, this could be achieved by reducing the target for net lending over a business cycle to -0.5 per cent of GDP. Such a change would increase Maastricht debt from 30 per cent of GDP (2027) to just over 35 per cent of GDP in 2035, which could be established as a benchmark for Maastricht debt during the next framework period.

A permanent reduction of the balance target to -0.5 per cent of GDP is compatible with the proposed long-term Maastricht debt anchor. If such a target is set, the target for structural net lending should be set slightly higher, because business cycles tend to be asymmetric.

It is important to emphasise that maintaining budgetary discipline by earmarking increased expenditure space for temporary, socially beneficial investments is essential. Also of essence is the effort to achieve a broad parliamentary consensus regarding the necessity of various socially beneficial investments, based on solid comparisons of different investments benefit in relation to their costs. It is important that the new arrangement under which socially beneficial investments are debt-financed is also subject to strict evaluation of their economic efficiency.

Changes in budgetary rules will facilitate fiscal stabilisation of the business cycle

A greater focus on fiscal stabilisation policy will require some budgetary rules to be adjusted and supplemented.

For an active fiscal stabilisation policy to be practically implementable in a recession or a boom, the structural balance must be allowed to deviate from the level that should apply when the business cycle is in balance. An active fiscal stabilisation policy in a recession will make the structural balance to fall below the structural balance that should apply when the business cycle is in balance, while the reverse will apply in a boom.

Changes in public expenditure for stabilisation purposes can be placed within a new expenditure area outside the expenditure ceiling, so that it becomes clear which expenditures in the budget are used for stabilisation purposes and which are undertaken for structural purposes. The benefit of making this distinction clear is that it reduces the risk that a more frequent use of active stabilisation policy leads to higher permanent public expenditure. The latter could be the case if the spending ceiling is changed repeatedly, or if the spending ceiling is set so high that its original purpose is circumvented. In addition, this can speed up the activation of stabilisation measures on the expenditure side of the budget.

Important that active fiscal stabilisation policy does not increase public expenditure

It cannot be avoided that an increased use of active fiscal stabilisation policy entails a risk that measures undertaken for other reasons will be categorised as such to escape requirements for financing. Fiscal policy way lead to increased costs for public finances. There are several ways to reduce the risk of this happening.

One way is to prevent this to happen is to introduce a maximum limit on the size of the active fiscal stabilisation policy (i.e. the size of the semi-automatic and discretionary fiscal policy measures), e.g. that it should not exceed the magnitude of the stabilisation of the economy that takes place via the automatic stabilisers, if there are no special reasons why the size should be larger.

Another way is to introduce an information requirement that stabilisation policy proposals to the Riksdag must contain assessments of the business cycle, the expected effects of the proposed measures, and a plan for when the temporary measures are to be withdrawn.

A third way is to establish a stabilisation policy board with the task of producing decision-making documents and making forward-looking recommendations on appropriate fiscal stabilisation policy (see previous section).

A fourth way is to strengthen the scrutiny of fiscal policy (see further next section).

Strengthen the independent review of fiscal policy by placing it under the Riksdag

If fiscal policy is given greater responsibility for stabilisation policy, it will also be important to strengthen the Riksdag's scrutiny of overall fiscal policy to ensure that the fiscal stabilisation policy meets its targets. Such scrutiny is vital in encouraging a high degree of confidence in the fiscal stabilisation policy. Such scrutiny can be strengthened by expanding the Fiscal Policy Council's mandate to audit the implemented fiscal stabilisation policies. To further strengthen such scrutiny, the Fiscal Policy Council could be placed as a body under the Riksdag and given additional resources for its increased responsibility.

An additional way to facilitate the Riksdag's review of the overall fiscal policy may be to increase the importance of the Government's written communications to the Riksdag regarding the fiscal policy framework. This can be done, for example, by clarifying in the Budget Act that the Government must present a written communication on the framework for fiscal policy, including goals and principles for budgetary policies, as well as the fiscal stabilisation policy. To ensure broad parliamentary consensus on fiscal stabilisation, the tasks of the parliamentary committee overseeing the surplus target could be extended to include oversight of the targets and principles in this policy area.

Modify the budgeting process to ensure broad support for the stabilisation and structural policy bills

The Government's budget process centres on the bills submitted by the Government to the Riksdag (Spring Fiscal Policy Bill, Budget Bill and amending budgets). The experience from the minority parliamentarism during 2010–2022 points to a need for changes to ensure that the basic idea behind the establishment of the current budget process remains intact. A new budget process should result in the Government obtaining sufficient support for its budget bill in an orderly fashion, while the Riksdag's majority can have an impact through increased influence in the budget process. By avoiding recurring conflicts of the type that have prevailed since 2010, the legitimacy of the budget process can be maintained.

To facilitate fiscal stabilisation policy, it is important to review the budget process to ensure that bills concerning the economy receive broad support in the Riksdag. One way to increase the chances of attaining such support is to create a new arrangement for political negotiations between the Government and the parliamentary parties in the Committee on Finance. To further facilitate such negotiations, the Budget Bill can be more clearly oriented towards structural reforms while additional amending budgets are mainly used to pursue fiscal stabilisation policy. This is partly because the lead times for the amending budget are much shorter than for the Budget Bill and Spring Fiscal Policy Bill, and partly because measures may be required in periods between regular budgets.

Necessary to supplement current fiscal policy framework with a framework for fiscal stabilisation policy

In summary, the economic conditions for stabilisation policy have changed since the current fiscal framework was launched in the 1990s. There are many indications that a greater role for fiscal policy in stabilisation policy is needed going forward. By supplementing the current fiscal policy framework with a framework for fiscal stabilisation policy, it is ensured that an increased use of active fiscal policy takes place in an appropriate manner, which ensures that the credibility of the public finances is maintained.