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Assessment and recommendations

Sweden's recent good macroeconomic performance allows policy-makers to focus on longer-term goals...

The performance of the Swedish economy during the recent international slowdown has demonstrated the value of a sound macroeconomic policy approach. After Swedish voters decided not to adopt the euro for the time being, the monetary framework continues as a well-designed inflation targeting regime. The budgetary framework has delivered solid public finances, providing room for automatic stabilisers to work during the recent global slowdown, while monetary easing helped to stabilise activity without compromising price stability. In addition, tax cuts and other discretionary policy measures have helped to underpin output. As a result, growth in both 2002 and 2003 surpassed the European average by about one percentage point, and the OECD has projected economic growth of around 2¼ per cent in 2004 and 2¾ per cent in 2005. Despite current softness in some economic indicators, once activity has clearly picked up pace and spare capacity shrinks, monetary policy will need to be tightened in line with the inflation target. Overall, Sweden is in the enviable position of being able to focus its economic strategy towards longer-term requirements, which is also the main theme of this Survey. GDP per capita has grown faster than the OECD average in recent years after a long period of slower than average growth. But maintaining Sweden's per capita growth rate will become harder in the longer term as the dependency ratio starts to rise. Thus, the government's renewed emphasis on policies to boost labour supply and potential growth is welcome.

... of raising living standards and maintaining the welfare state as the population ages

As in many other OECD countries, the working-age population will start to shrink towards the end of this decade unless it can be supplemented by net immigration, while the old-age dependency ratio will start climbing quite sharply. In this context, the two broad economic policy challenges facing Sweden are to:

- Continue raising living standards through faster productivity growth and greater utilisation of resources available in the economy.
- Maintain the solidarity principles of the welfare state, despite a sharp increase in the dependency ratio.

More product market competition could boost productivity growth...

Establishing the conditions for greater product market competition is part of the answer, given its central role in bolstering productivity growth. Over the past 10 to 15 years, Sweden has strengthened competition legislation and deregulated a number of sectors, including electricity, telecommunications and parts of transport. The scope for competition from non-agricultural imports has also been augmented by increasing economic integration within the European Union. However, Sweden may not obtain the full benefits from these reforms until all its product markets are sufficiently exposed to competition, and labour and capital are able to move quickly to their most productive uses.

... but the institutional framework needs strengthening

Vigorous competition needs to be underpinned by both a strong institutional framework and vigilance in identifying and eliminating anti-competitive behaviour. Although Sweden's arrangements are already broadly in line with international best practice, there are several ways in which the approach could be rendered more effective:

- Strengthening the Competition Authority's capacity to combat hard-core cartels and other serious breaches of competition law so that fear of detection, prosecution and damaged public image provide an effective and strong deterrent to collusive behaviour.
- Providing for substantial sanctions on individuals actively and knowingly engaged in anti-competitive activities in a way that reinforces the effectiveness of the newly introduced leniency system.
- Streamlining the process and reducing the time taken for competition cases to be dealt with.

Specific measures could increase competition in several sectors...

More competition could be injected into several sectors, including some areas where extensive improvements have already been made. This could involve the following:

- Making further investments in the Nordic electricity infrastructure including the Swedish system to reduce the scope for any producer to exercise market power at times when transmission bottlenecks prevent the regional Nord-pool electricity market from functioning efficiently.
- Exposing all the activities of the state-owned passenger rail company to competition, including inter-regional routes, and requiring it to operate under a hard budget constraint, with no prospects of further government capital injections to bail it out.
- Eliminating the tendency towards collusive behaviour in building and construction by tougher enforcement of competition law.
- Examining carefully the equity and efficiency implications of a more market-oriented allocation of rental housing, instead of the present controls on rent-setting.
- Modifying the planning process to require that the benefits of increased competition be explicitly taken into account when local authorities are deciding on applications for supermarket sites.
- Considering alternative regulatory mechanisms that would allow the introduction of competition for retailing of alcohol without sacrificing control over access to liquor.

... while the public sector should operate on a level playing field

There is also room for greater efforts to boost competition in Sweden's large and decentralised public sector and in its interactions with the private sector. Over the longer term the Swedish authorities should consider whether the private sector is better placed to provide some of the goods and services that the public sector currently provides. Although the government has taken a number of steps already to increase exposure to competition and to promote a more level playing field, some further changes would help, including:

- Strengthening the legal framework governing the market activities of municipalities and other public institutions, bringing them clearly within the scope of the competition

legislation and providing greater opportunity for competitors to seek redress.

- Rationalising the present supervisory structure for public procurement into a single agency covering all levels of government and with scope to impose sanctions, and modifying legislation to require that tenders from internal units and external suppliers be treated equally.
- Increasing outsourcing of public services, which would not only boost competition and lead to higher quality and/or lower costs, but would also provide more opportunities for nascent entrepreneurs to emerge in currently under-developed parts of the personal and social services sector.
- Monitoring more effectively the activities of state agencies and their effects on competition, which would also demonstrate the government's commitment to promoting competition in the public sector.

More generally, efforts need to be made to ensure that all rules affecting private and public suppliers are designed so that providers can compete on fair and equal terms in every respect.

Young people could complete education more quickly...

Expanding the country's output depends on making effective use of its available resources through overall labour utilisation and by ensuring that labour productivity is maximised. With already high employment rates overall, policies are now being reoriented to target those groups where participation is especially low and where there is scope for increases. One such group is young people, who could complete their education and enter the workforce at a younger average age if the rules for admission to tertiary education were rationalised to facilitate the transition from secondary to higher education and to encourage improved performance in upper secondary school. The incentives for more rapid completion of post-secondary education would be strengthened, for example, by further limiting the availability of study grants to the normal duration of study programmes. The merits of shifting to a more direct "voucher" type of arrangement for funding of tertiary education could also be considered as a mechanism for more efficiently matching supply and demand for places within the tertiary system.

... and immigrants need jobs to integrate faster into the economy

Immigrants are also under-represented in the workforce, with a significantly lower participation rate than native Swedes. The reasons for this are complex, not least because immigrants are a heterogeneous group and may face a range of obstacles to economic integration, depending on their circumstances. Improving their labour market prospects will require a combination of greater efforts to improve their language and job-related skills and appropriate activation strategies, as well as vigilance against discrimination. Low-skilled foreigners face an extra hurdle because the economy has relatively few jobs at their level, given the wage compression that is a hallmark of the Swedish model of the labour market. If the social partners concentrate wage increases on raising the lowest pay rates in forthcoming agreements, this will make it harder for the low-skilled, whether immigrants or native Swedes, to find jobs commensurate with their current skills and productivity levels.

Sick leave needs to be tightly administered

Effective labour supply is also restricted by people absent from the workplace because of sickness, while long-term sick leave and disability pensions have provided a permanent exit route from the workforce for some older workers. Indeed, the growing recourse to sick leave in recent years has made it one of the most urgent labour supply issues to address. The government has made strenuous efforts in the last year to curb the upward trend by tightening administrative controls and giving employers a stronger incentive to reduce its incidence. It also intends to convert disability pensions into time-limited, though renewable, sickness compensation. To be effective, these measures need to be enacted as intended in every local social insurance office; strengthening the powers of the national agency over local insurance boards would help to ensure this. If the measures already taken do not yield strong and durable reductions in days lost, further control measures to address moral hazard will need to be considered: this would avoid the less palatable alternative of scaling back benefit rates significantly.

Income tax cuts should focus on reducing high marginal tax rates

Boosting average working hours is another way of raising labour utilisation. While trimming back working hours is a natural response to rising living standards, in Sweden's case, hours worked are also heavily influenced by high taxes on

labour income. But fewer working hours diminish the output produced, shrink the tax base and make it harder to finance the welfare state. At the same time, negotiated cutbacks in working hours may also push up the overall cost of labour-intensive public services, where offsetting productivity gains are difficult to achieve. Taken altogether, the long-term implications for public finances of reduced hours would be significant, and it is therefore crucial to moderate the tax burden on earned income. Once the last step of the current programme of cuts is implemented, future tax reforms could concentrate on producing stronger labour supply benefits by further lowering high effective marginal tax rates on earned income. In addition, reducing the state income tax would be justified in order to increase returns to education and promote growth in labour productivity. The revenue foregone could be financed by trimming public spending, reducing tax expenditures, raising taxes on property and removing preferential VAT rates and/or preferential treatment of pension savings.

Obstacles to job mobility could be reduced

The productivity of labour resources depends partly on whether they are able to move easily and quickly in response to changes arising from vigorous product market competition. Swedes stay longer in the same job than do employees in other countries, which can have advantages for developing firm-specific human capital. But it may also mean that some workers remain in jobs where their output is smaller than it would be if they moved to another position where their productivity could also grow more rapidly over time. Sweden's relatively strict employment protection legislation may persuade workers to stay where they are, rather than risk moving to a different job – even if it would suit them better than their current one – because of the associated loss of job protection. The bias against hiring older workers, in part reflecting employment protection rights, also discourages job mobility. Furthermore, with wages still relatively compressed, it can be more difficult for workers to identify opportunities for increasing their long-term earnings by moving to a higher productivity position. These aspects of the labour market could be addressed by:

- Amending employment protection legislation so that a better balance is struck between providing job security and facilitating the movement of people to jobs where

they are most productive, where their earnings potential is greatest, and where they would prefer to be.

- Allowing relative wages to play a greater role in providing information about the demand for workers and skills between firms, sectors and professions. As wages are negotiated between the social partners, this may involve bargaining outcomes that reflect a greater tolerance for wage dispersion.

Tax rules distort investment decisions...

Raising inter-sectoral capital mobility could also contribute to higher productivity. Current tax rules inhibit the process of shifting capital rapidly to its most productive uses. Although Sweden's corporate tax regime is internationally competitive, more uniform tax treatment of different forms of corporate finance and different types of investment would improve efficiency. A cut of the tax rate financed by base-broadening measures could contribute to this. Wealth taxation discourages households from saving outside of institutional vehicles such as occupational pension schemes and may make it more attractive to hold assets offshore for tax reasons.

... and also discourage entrepreneurial activity

Entrepreneurial activity is one of the most important, though elusive, elements of a dynamic economy. It is still weak in Sweden, although the government has given it more emphasis and public attitudes have become more favourable in recent years. Several factors work against entrepreneurial efforts. The more favourable corporate tax treatment of debt is disadvantageous, especially for small companies and start-ups, for which equity financing is often more appropriate. The income splitting (so-called "3:12") rules applying to closely held companies provide a neutral treatment of different organisational business forms and prevent large-scale income shifting in the dual income tax system. Although the imputed capital income formula has been chosen to reflect an average *ex ante* risk premium, it nevertheless limits the *ex post* rewards for risk-taking and remains relatively onerous for highly profitable businesses, even after the recently announced changes. The risks associated with shifting from employment to self-employment may also be magnified by the loss of accumulated employment protection and the high weight of previous earnings in the amount of unemployment insurance benefit. Overall, it may

be unrealistic to expect entrepreneurs to flourish in such a climate, which almost certainly could be improved with very little overall impact on public finances.

Joint rewards to institutions and inventors would stimulate commercialisation of R&D

Although innovation is clearly important for technical progress, Sweden's high rate of investment in R&D does not appear to have yielded commensurate increases in aggregate productivity that would contribute to long-term economic growth. This suggests that it would be appropriate to maintain a relatively cautious approach to policies for R&D *per se*, and the optimal strategy would ensure that economic conditions overall provide market-based financial rewards to firms that innovate. However, in the public sector, the incentives to commercialise research could be strengthened by sharing the intellectual property rights between the researcher and the employing institution. Setting up structures that help institutions develop effective strategies for bringing research to market could also facilitate technology transfer. A similar approach could also help diffuse innovative practices within the public sector and stimulate employers and employees alike to search more actively for such improvements.

Ageing will put public finances under pressure...

While boosting labour utilisation and productivity will help maintain GDP growth at a higher rate, Sweden's rising dependency ratio over coming decades implies substantially greater redistribution *via* public finances. The reforms designed to put public pensions onto a robust financial basis have eased future budgetary pressures significantly. Nevertheless, health and elderly care expenditures are still expected to absorb a steadily rising share of GDP over the next 40 to 50 years. These pressures will be attenuated by greater utilisation of available labour, especially where it involves people shifting from public benefits into employment, but it will also require vigilance in the management of public finances.

... but strong financial surpluses for the next 15 years would help

The government, well aware of the importance of good fiscal management, has set itself the ongoing target of a fiscal surplus of 2 per cent of GDP over the cycle, in order to provide for long-term sustainability of public finances. Achieving this target for the next 15 years or so would allow

net assets to be accumulated that can later be drawn down to finance the additional spending pressures arising as demands on health and elderly care services climb. With a prudent fiscal framework in place, Sweden's public finances are already in much better shape than in most other OECD countries and the country has virtually no net public debt. According to OECD estimates, structural budget surpluses have averaged around 1¾ per cent of GDP since 1997. But tax cuts and expenditure increases, including for sickness and disability benefits, have produced an estimated structural surplus of only ¼ per cent of GDP in 2003. Hence, strict fiscal discipline will be necessary to achieve the government's objective of a 2 per cent surplus over the cycle. The costs of slippage in meeting this target could be significant and might jeopardise long-term fiscal sustainability.

Central government budget margins need to be preserved...

The government's present projections show a return to a 2 per cent general government surplus by 2006, but only on the assumption that outlays remain well under the expenditure ceilings. If additional spending were to eat up these margins, as has tended to happen in the past, then the return to a sustainable longer-term path would be delayed, unless taxes were raised. This alternative is unpalatable, given the already very high tax wedges. The risk could be reduced if the expenditure ceilings were redesigned to ensure that budget margins are not used for discretionary spending, but reserved for unexpected macroeconomic fluctuations. For the same reason, implementation of the 121-point plan agreed between the government and its supporting parties would compromise the medium-term path if it involved additional spending: adhering to the political commitment to finance any new measures is thus crucial. More generally, ongoing reassessment of expenditure priorities and pruning low-priority programmes would help to make room for new initiatives and/or further tax cuts.

... and upward trends in local government taxes and expenditures curbed

Local authorities are also facing growing expenditure pressures, which translate into higher tax rates because they are required to balance their budgets. Large local tax hikes have partly undermined the labour supply benefits of the state income tax cuts. At the same time, the equalisation

scheme may to some extent discourage local authorities from expanding their tax base. One option might be to shift part of local governments' revenue base to property, which would also make local tax revenues less susceptible to fluctuations in economic activity, while another alternative would be to make counter-cyclical adjustments to state grants. Both of these would reduce the tendency for the present balanced-budget rule to ratchet up local expenditures during economic upswings, and then increase tax rates when activity slows.

Refining the fiscal framework would help long-term policy appraisal

For the longer term, it would be useful to refine the current framework so that all the instruments and targets are brought together in a more integrated and transparent way. This would involve interlinking the expenditure ceilings, the balanced budget requirement on local authorities and the employment rate target of 80 per cent with the government's objective for the national accounts-based general government surplus. It would also make it easier to assess the additional policy efforts required, indicate how improvements on one element would flow through to the others, and provide a consistent benchmark for measuring progress against long-term objectives.

Environmental policies have been successful, but the cost-effectiveness of policy can be improved

Another element of long-term sustainability concerns the environment. Considerable progress has been made in reducing air and water pollution and increasing recycling rates. Further policy developments in these areas would benefit from greater use of cost-benefit analysis.

- For air pollution, further progress requires action reducing emissions of particles from mobile and smaller sources. Aligning vehicle taxes with emission characteristics and encouraging the purchase of lower-emission domestic boilers would be effective instruments.
- With respect to water pollution, measures aimed at reducing nitrogen balances of farms and trimming back agricultural support could help in meeting nitrogen load targets. However, due to the high costs of meeting pollution targets for the Baltic Sea in Sweden alone, an agreement with other states on introducing an area-wide

abatement trading scheme would yield more efficient results.

- Waste management and recovery policies could be based more clearly on cost-effectiveness, in order to meet policy objectives at least cost, and avoid using policies that exceed the external costs at the margin. For example, the prohibitions on landfilling could be relaxed in some regions to allow greater flexibility in implementing waste management policy using the most cost-effective option.

Summing up

With sound monetary and fiscal frameworks and a good macroeconomic position, Sweden is better placed to face the longer-term challenges of an ageing population than many other OECD countries. As elsewhere, these demographic trends will put downward pressure on growth in potential output and increase burdens on public expenditure over time. Managing this situation effectively within the welfare state approach while enjoying the highest possible living standards will be easier if the country can raise productivity growth, expand the effective labour supply, and get public finances quickly back onto their intended medium-term path. Productivity growth could be boosted further by increasing the pressures from competition in all parts of the economy, building on earlier liberalisation efforts. Effectively addressing cartels and other anti-competitive behaviour, removing regulatory obstacles and further exposing the large public sector to competition would all help. Productivity growth could also be raised if workers and capital moved more quickly and easily in response to shifts in costs and demand for different outputs. However, taking the rewards for productivity improvements in the form of lower working hours diminishes the tax base; further reductions in high marginal tax rates would reduce the incentive to do so. Although employment rates are already high overall, more could be done to get young people qualified and into the workforce earlier and to improve the integration of immigrants. Reducing the numbers of people drawing sickness and disability benefits will not only boost effective labour supply but also help ease expenditure pressures. More generally, tight

expenditure restraint will be necessary to attain the government's surplus target. The budget framework could be refined in ways that would help to ensure that public finances are sustainable in the long term, while also providing room to moderate marginal tax rates in order to boost incentives to work, save and invest. Further progress towards environmental sustainability could focus on improving the cost-effectiveness of policies. Ultimately, creating faster growth and maintaining the welfare state depend on continuation of far-sighted economic management.

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BASIC STATISTICS OF SWEDEN

THE LAND

Land area (1 000 sq. km)	411	Inhabitants in major cities, including suburbs (31 December 2002) thousands	
Lakes (1 000 sq. km)	39	Stockholm	1 684
Arable area (1 000 sq. km) (2002)	27	Göteborg	810
Woodland (1 000 sq. km) (1997-2001)	226	Malmö	533

THE PEOPLE

Population (31 December 2002), thousands	8 941	Net natural increase per 1 000 inhabitants (average 1998-2002)	-0.4
Number of inhabitants per sq. km	22	Net migration (average 1998-2002), thousands	21.9
Net natural increase (average 1998-2002) thousands	-3.1		

THE PRODUCTION

Gross domestic product in 2002 (Kr billion)	2 340.0	Gross fixed capital formation in 2002	
GDP per head, USD	27 000	Per cent of GDP	17.1
		Per head, USD	4 612
		Employment, 2002:	
		Total civilian, thousands	4 241
		Per cent of total	
		Agriculture, forestry, fishing	2.1
		Industry	23.1
		Other	74.6

THE GOVERNMENT

Per cent of GDP in 2001:		Composition of Parliament	Number of seats
Public consumption	26.7	Social democrats	144
General government current revenue	57.3	Moderates	55
Public gross fixed capital formation	2.3	Liberals	48
		Christian democrats	33
		Left	30
		Centre	22
		Greens	17
		Total	349
		Last general election: September 2002	
		Next general election: September 2006	

THE FOREIGN TRADE

Exports of goods and services, 2002 (per cent of GDP)	45.4	Imports of goods and services, 2002 (per cent of GDP)	34.9
Main merchandise exports (per cent of total)		Main merchandise imports (per cent of total)	
Forestry products	14.0	Forestry products	3.5
Mineral products	9.6	Mineral products	8.3
Chemical products	11.3	Chemical products	10.8
Energy products	3.0	Energy products	8.9
Engineering products	50.8	Engineering products	47.8
Other products	11.3	Other products	20.7

THE CURRENCY

Monetary unit: Krona		Currency units per USD, average of daily figures:	
		Year 2003	8.08
		January 2004	7.25

Note: An international comparison of certain basic statistics is given in an annex table.

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