HOW THE SWEDISH MODEL IS WORKING

Summary of the state and how it got there

The Swedish Trade Union Confederation

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Summary

– The tax system was reformed in 1990–91. It should become uniform, i.e. equal tax on all types of incomes. Broad tax bases result in low marginal tax rates.

– The pension system has been reformed. Pension is now based on all active years which means it takes more work effort to reach full pension.

– Sweden has changed economic regime with an independent central bank with a 2 per cent inflation target and a surplus target for public finances of 2 per cent over the business cycle. This has helped to remarkably improve the economic performance.

– The security systems on the labour market were a prerequisite of enabling reforms of the product markets, which in turn have helped Sweden reaching a higher growth level.

– The employment has increased since 1995, but the share of those not being absent was the same in 2004 as in 1995. The damage from the 1990's crisis is not restored yet.

– Two challenges for the Swedish model: too low employment and the long term trust in public security systems. To manage the financing of the welfare state, the in-work rate must increase. And assurance solutions should be found to decrease the households' need to save.

– There are higher demands in working life than before. Moreover, the so-called working line, central in the Swedish model (right to support in case of unemployment, combined with a demand of activity), has not been given enough attention. Above all, people have not been given the possibility to contribute in the labour market according to ability.

- For the welfare state to be sustainable, equal opportunities for men and women become more important, the effective retiring age must approach the formal (65 years) and integration and thus employment rate for people born abroad must improve.

- The stabilisation of wage formation has generated positive effects such as increased real wages, less conflicts, more stable profits and lower interest rates.

- The stabilisation policy must be shaped in order to jointly create growth and price stability. When both monetary and fiscal policies are contractive, the process of adaptation is much extended.

- The Swedish central bank should pursue its monetary policy in a more symmetric way. Today it tends to rather overestimate than underestimate the risk of inflation. Due to the budgetary ceilings the government is often forced to resolve problems by savings in public finances, tax cuts and supply reforms. The fiscal policy needs more room for manoeuvre.

- Swedish economy is affected by declining demand and has not been able to sufficiently increase the employment rate. The framework has given stability in public finances but not enough stability in employment.

Most people underestimate how much the Swedish model has changed since 1990. At that time Sweden had high inflation, deficits in both trade balance and the state's budget. The growth in productivity was weak and cost increases were higher than in the surrounding world, yet employment was high and unemployment was low. The cost development was not compatible with a fixed currency rate. Since then quite a lot has happened.

Taxes and pensions

THE TAX SYSTEM was thoroughly reformed in 1990–91. The basic idea was that the tax system thereafter should be characterised by economic rationality and distributional justness. The progressivity was heavily decreased to make way for broadened tax bases. A main principle was that the tax system should as far as possibly be uniform, i.e. equal tax on all types of incomes, regardless of how they were earned.

A dual tax system was introduced, i.e. separate taxation of labour and capital incomes, where capital incomes were taxed with 30 per cent and the highest marginal tax rate on labour income was decreased from 72 per cent in 1989 to around 50 per cent. The base for labour taxation was also broadened by widening taxation on fringe benefits as car benefits and beneficial loans. The bases for taxation of capital and capital gains were broadened and the value of rate deductions decreased. This contributed to reduced possibilities of tax planning, which is very important from a distributional point of view. The base of value-added tax was widened in order to attain a uniform and general taxation of products and services.

In general, Sweden is often recognised as the country with the highest taxes, in relation to GDP. To a great extent, this reflects a higher level of social welfare objectives. In this context, Sweden is part of a group of northern European countries with similar ambitions in the general welfare systems. Sweden also has among the highest levels of taxation of each of the various tax bases. This does not apply, however, to company taxation. The Swedish system contains relatively few tax exemptions, such as standard deductions and tax relieves. The broad bases result in relatively low marginal tax rates in relation to the total level of taxation.

The pension system has also been reformed. Sweden and Italy were among the first to introduce a partly fee-determined system. Earlier the system had been benefit-determined, i.e. the fees were adjusted to the cost. The pension system is above all a pay-as-you go system, but does also contain a small fund based part. A so-called brake exists within the system which lowers the pension rights if the expected expenses exceed the expected incomes. This means that if the economy does not function properly with high growth and employment, the pensions will decrease. In this sense, the pension system is self-financed and cannot as earlier push aside other public expenses. Earlier the pension rights were based on work during 30 years of which the best 15 years were decisive. Now pension is based on all active years which means it now takes more work effort to reach full pension. Work after the official pension age of 65 years increases the pension, and earlier withdrawal decreases it. The reform created strong driving forces for increased work efforts.

Independent central bank and new fiscal policy regime

SWEDEN HAS CHANGED ECONOMIC REGIME with inflation as a clearer restriction. Earlier the inflation rate was around 8 per cent whilst the inflation target now is 2 per cent. This target is upheld by an independent central bank. A new budgetary system has contributed to making the public expenses, as part of GDP, the lowest in 30 years. This required reduced subven-

Indicators for the Swedish-economy 1990, 1995, 2000 and 2004

	1990	1995	2000	2004
Employment, 16–64	83,1	72,2	74,2	73,5
Unemployment, 16–64	1,8	8,4	5,1	6,0
Total , unemployment 16–64	3,1	13,0	7,7	8,4
In-work rate, 16–64	67,7	61,4	62,4	61,2
Inflation, CPI	10,5	2,2	0,4	0,4
Real interest rate, short	3,2	6,5	3,6	1,7
Increase of ULC	9,7	– 0,4	6,3	– 1,6
GDP per capita relatively USA	81,5	77,4	77,9	76,4
GDP per capita relatively EU-15	111,3	105,8	109,4	108,9
Public debt, gross	43,5	78,3	58,2	47,7
Public debt, net	– 7,8	25,2	1,2	– 5,2
Public savings, % of GDP	3,8	– 6,9	5,0	1,0
Current account, % og GDP	– 2,6	3,4	4,1	8,0
Household saving quota, % of disposable income	– 0,2	6,5	– 1,7	4,5
Tax quota, % of GDP	53,3	49,5	53,9	50,6
Expense quota	54,1	58,1	50,6	52,5
Sickness benefit & early retirement pension, thousands full year equivalents	531	503	589	663
Profit share, business sector	29,4	41,6	37,2	36,5
Productivity, business sector	1,8	3,3	4,0	4,3
Household wealth, % of disposable income	389,3	292,4	445,5	408,5
Investments, % of GDP	23,1	16,0	17,7	16,0

Sources: KI, OECD, SCB and own calculations.

tions to housing construction. A surplus target for public finances of 2 per cent over the business cycle means that the public debt is decreasing and that the public assets are bigger than the debt.

The Social Democrats in Sweden have been remarkably good in modernising the Swedish economic model. The Swedish prosperity, measured as real GNP, has increased by 2,5 per cent a year since 1995, which is the same rate as in the USA but half a per cent higher than the EU-average. The level of foreign indebtness has dramatically improved as well as that of the public debts. The state now has more financial assets than debts; the rates and the inflation are low. Sweden comes second in the Lisbon ranking as regards structural transformation. However, income distribution in Sweden has become more unequal and wage disparities increase steadily.

The strategic choice made, as can be observed afterwards, was to influence the effectiveness of the economy while keeping the regulations on the labour market more or less intact. The security systems on the labour market were a prerequisite of enabling prompt reform of the product markets.

There are many signs indicating that Sweden has entered a higher growth level, perhaps to a great extent thanks to regulatory reforms. This does not just signify that Sweden is temporarily "taking a great leap forward" as regards GDP, but it seems that the long-term increase in productivity is higher than before. After a change of the line of policy towards low inflation and stable public finances, the total factor productivity has increased. It means that the raise in productivity is effected not only through an increase in the capital and working hours invested, but also through improved efficiency in the use of resources.

The table above summarises the Swedish development since 1990. In comparison to 1995, most things have improved until 2004. One can not neglect the state in 1990, even though this year must not be seen as an ideal year. The employment has certainly increased since 1995, but the share of those who effectively do work, not being absent, was the same in 2004 as in 1995. The wounds from the 1990's crisis have not healed yet.

There are two almost eternal tasks which are now challenging the Swedish model. Firstly, the low employment, and secondly, the long term trust in the public security systems. A prerequisite of this trust is that the public sector will have sufficient incomes during the coming 20 years.

Today the incentives to work are in the centre of the political debate. We are the first ones to uphold that work should always pay but one must understand that economic incentives are much more complicated than salary after taxation. Since the introduction of individual taxation three decades ago, the policy has focused on increasing incentives to work. The main efforts were the tax reform, the pension reform and the tariff ceiling for day nursery.

The criticism that right wing politicians have directed towards lacking incentives for work is exaggerated. The high subvention for child care and the rules of qualification for parental insurance have led to more mothers with children younger than six years working than in most other countries. The wage earners receive, thanks to collective agreements and law, between 20–30 per cent more in social compensation in addition to salary. The requirements to qualify for sickness benefit and pension create strong incentives to work.

Despite strong incentives to work, employment does not increase. 64,5 per cent of the work force are at work a normal week. The share of persons on sick leave is higher than in most countries, but Swedes are not more ill than others. This is explained by more older people in the work force. To manage the financing of the welfare state, the in-work rate must increase to 70 per cent.

A larger share of Swedes has foreign origin than for example in Germany and France. Sweden has shifted from labour immigration to immigration steered by a combination of asylum reasons and economic migration. The employment rate for Swedish born was 79 per cent in 2002, whilst 67 per cent for those born abroad. The present policy of integration is not compatible with the demand for increased worked hours in the economy.

A central Social Democratic idea is that the majority of the unemployed should be in active measures and that few should receive only cash support. All this in order to support the individual and to decrease the possibility of voluntary inactivity. Activity is necessary to create legitimacy for tax payers' expenses. The activity rate within the labour market policy has now however decreased from 40–50 per cent to 30 per cent. The critics of the sickness benefit have probably had impartial ground and the number of sick and early retired has increased. The application has now become stricter.

There are higher demands in working life, 30 per cent more older people in work and 100 000 people born abroad have difficulties in being employed. Despite this, the number of persons in so-called sheltered employment, which is independent of business cycle, has been unchanged since the beginning of the 1990's. Wage subsidy, which is a subvention to employers in order to create employment according to the individual's possibilities, has been maximised at 13 800 SEK per month during ten years. It has now increased to 15 000 SEK, but should really be some 25 000 SEK a month. Is it then surprising that sick reporting has increased and that suspicion of overuse of benefits arises? The bitter truth is that enough attention has not been paid to the Swedish model, namely the so-called working line (right to support in case of unemployment, combined with a demand of activity). Above all, people have not been given the possibility of fulfilling work according to ability.

There are three things Sweden has to achieve for the welfare state to be sustainable. Women must to equal extent as men have full-time employment as a norm in the labour market. This assumes economic incentives to pass from part-time to full-time, and that men and women share an equal responsibility for the children. Equal opportunities become more and more important to upholding a welfare state. Secondly, new norms and economic incentives are needed as to make the effective retiring age approach the formal one, which in the Swedish case is 65 years. Thirdly, the integration policy needs a new start. The target must be an employment rate for people born abroad of at least 80 per cent.

Should the wage-earners be satisfied?

THE BASIS FOR MANY economic discussions is that the European labour market would be too rigid and that wages are not flexible enough. We do however believe real wages are flexible. The European wage-earners have in principle had a zero percentage real wage development 1997–2003. Manufacturing agreements have been settled in Germany which would increase costs with 2 percent per year, at the same time as productivity has increased 3 percent and inflation was 1 percent.

Real wages increasing less than productivity indicates that profit levels have increased. The fact that the process towards increased employment is slow is explained by a weak elasticity between real wages and employment. It takes a 1 percent decrease in real wage to increase employment by 0,2 percent. If the aim of a rigid policy is to increase employment, it can be concluded that it will take a long time before any results will show. When accordingly neither monetary nor fiscal policy is allowed to be expansive, the process of adaptation is much extended.

Few thought in 1985 that such modest wage increase rate was possible in Sweden, as were the results of the latest collective bargainings. The stabilisation of wage formation has generated positive effects such as essentially increased real wages, less conflicts, probably more stable profits and much lower interest rate. This stabilisation turned out to be a necessary but insufficient condition for an economy with high and stable use of resources.

In wage bargaining there is a game theoretical problem which consists of the possibility of different players to deceive each other in the short run. Above all, the game takes place between different groups of wage earners. For this reason a trustworthy threat from an external party affects the outcome of wage bargaining. Due to lack of an employer partner which coordinates the labour market and keeps a fixed wage norm, it makes it easier for LO to create a norm of reasonable wage increase rate.

Macroeconomic policy

ONE WAY OF SHOWING differences in monetary policy is to compare inflation in recent years. Between 1995 and 2005, the Swedish inflation has been 1,1 percent on average, and 2,0 percent in the EMU area.

This implies a dilemma on how to shape the stabilisation policy in order to jointly create growth and price stability. It is necessary to have a good functioning of both the labour market and the product market. However, structural policy cannot replace a balanced aggregated demand. Experiences show that changes are easier carried through when the economy is growing. Both professional and geographical mobility are increased along with increasing demand.

Our belief is that the current regime of stabilisation policy, i.e. the combination of the central bank's inflation target and the limiting rules of fiscal surpluses, creates an unreasonable burden for the allocation policy (this could on EU level be compared to ECB's inflation target and the limiting rules of the Stability and Growth Pact).

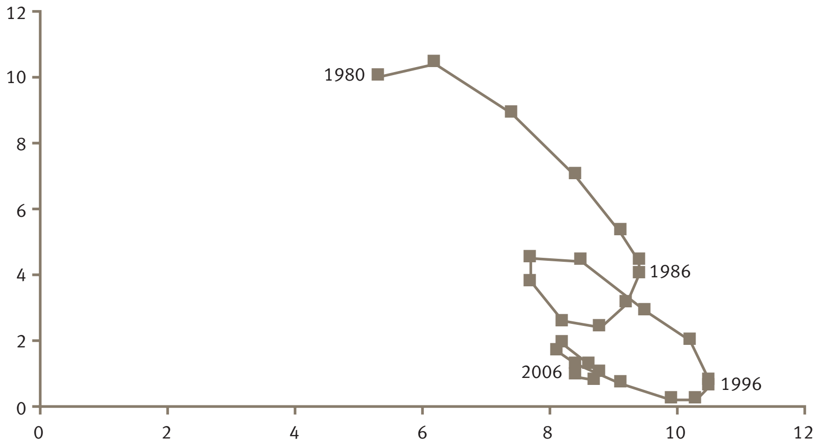
The Phillips' curve shows the trade-off between unemployment and inflation. Sweden and EMU have different Phillips' curves: within the EMU a high unemployment rate, approximately 8,5 percent, is consistent with an inflation rate of 2 percent. The equivalent unemployment rate is 6,5 percent for Sweden.

There is an economic theory stating the optimal inflation target to be well above 2 percent.[1] Estimates for Sweden have accordingly pointed out that the interval 2,5–4 percent would be more appropriate as inflation target, whereas today's target is 2 percent. It is not certain however, that these findings would be enough to carry out a radical change of policy. Revising the inflation target brings a risk of expectations of increased inflation.

The question is whether the government and parliament can pursue a policy which stabilises the real economy? One might wonder if not an

1 Ackerlof, Dickens & Perry (2000),"Near-rational wage and price setting and the long-run Phillips curve". Brookings papers on economic activity, 1:2000.

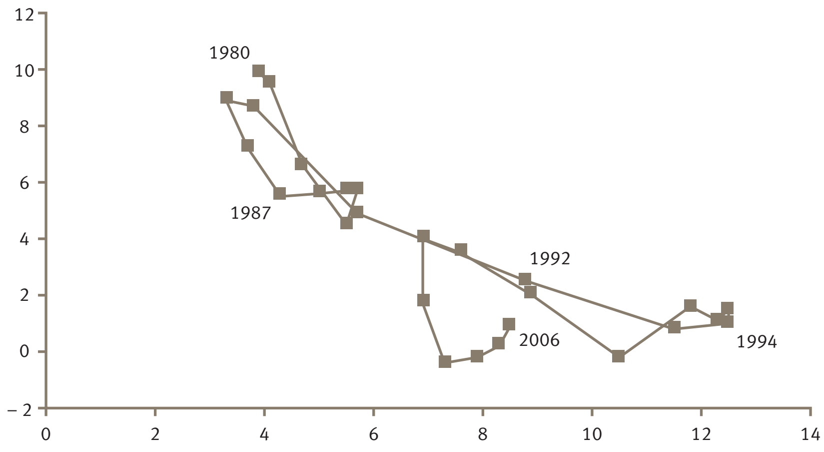
EMU's Phillips' curve 80–06



Source: Economic Outlook 74, OECD.

Chart 1

Sweden's Phillips' curve 80–06



Source: Ekonomiska Utsikter, LO 2005.

Chart 2

increased activism from the government means a risk of double command of the economic policy if the actors who are responsible for fiscal and monetary policy respectively, on short term make different interpretations of the economic development. However, the monetary policy will always be affected by the fiscal policy. Monetary policy is thereby an important instrument to counteract opportunistic fiscal policy. Also this is a strong reason for an independent central bank

To create a long-range perspective and make the role of the fiscal policy within the stabilisation policy clear, LO economists are arguing that it should be conformed to an easy and comprehensive framework of rules. Some of the main points in such a framework are:

- Targets for the fiscal policy. The fiscal policy should prevent recessions as well as extreme booms. This should be added to the existing targets of surpluses and expenditure ceiling of the public finances.
- Levelling out of municipalities' income over longer periods of time. The budgets of the municipalities and county councils today tend to be procyclical, with too high expenditure during booms and too modest ones during recessions.
- An employment margin within the budget. When unexpected changes arise in unemployment, there must be sufficient space for automatic stabilisers (unemployment benefit) and semi-automatic stabilisers (for example expenses for vocational training).
- Margin for action within the budget. This should be used for discretionary measures during severe recessions. For example different types of vocational or labour market measures, or to give priority to public investments demanding increased public expenses.

Wrong diagnosis – wrong medicine

BEFORE LAYING ALL STRENGTHS on resolving "structural" problems, the question if Sweden's aggregated demand is balanced should first be considered. We believe there is a problem of demand, and that policy therefore should not unilaterally be aiming at structural problems. The first conclusion to be made is that our central bank should pursue its monetary policy in a more symmetric way. Today there is a target of 2 percent allowing a variation of inflation of ± 1 percent. The actual inflation rate in recent years shows that the bank tends to rather overestimate than underestimate the risk of inflation.

There are also problems of supply and rigidities on the labour market. But as it is now, the economic policy pursued is decreasing the possibilities of increased employment which would also enforce public finances. The government is forced to resolve problems by savings in public finances, tax cuts and supply reforms, i.e. increasing the motive force for unemployed to accept any vacancy and deregulation of product markets. A more expansive policy would increase employment and thereby also public income.

Even though it is a powerful instrument, there must not be an overconfidence in the ability of monetary policy to steer the economic development. There must also be a reasonable chance to pursue a fiscal policy of stabilisation, promoting employment and growth.

The fiscal policy needs room for manoeuvre by avoiding excessive budget deficits and demands of surpluses. The latter would of course imply calling upon the state to pursue a Keynesian policy (in contrast to an accounting and bookkeeping policy), supporting a building up of buffers in the public finances to be used in important economic disturbances. The very aim is to combine a sustainable fiscal policy with the demands arising from demography.

LO has for a long time demanded a change within the system of expenditure ceilings, which should allow a greater room for manoeuvre for the automatic stabilisers, and for possibilities to stimulate the economy during recessions. Despite the obvious need, the government has not yet introduced these margins. When the government now is saying that they can afford to counteract the unemployment, it talks in a book-keeping way, as before Keynes. During the latest recession, the public indebtness has decreased. In the budgetary proposition of 2005, which is said to stimulate employment, the public surpluses were increasing despite a stagnating or just weakly increasing employment.

The question is whether the current distribution of work between the government and the central bank, with a surplus target and application of the "working line", simply results in a too low employment rate for the welfare state to be sustainable? Considering the employment policy, we cannot be satisfied. One could, as the right-wing politicians and many economists, assume that the problem is a lack of willingness to work. But this could hardly be the conclusion of the Social Democrats. Thus, other answers should be looked for.

Trust in the future

THERE WERE GOOD ARGUMENTS for the tightening up of the fiscal policy made in the middle of the 1990's. It was necessary to increase the trust in the state so that the interest rates could decrease. It was not reasonable to leave a large and growing public debt to coming generations.

However, the expense ceilings have been constructed to lead to shrinking public expenses as share of GDP. The public share of expenses has not been as low for 30 years as it is now. They are thereby not compatible with an opinion wanting increased expenses. And the system implies that the public expenses do not counteract the business cycle.

Is the Social Democratic policy which won victories during past mandate periods also the way to success for coming periods? An economic-political system can be valued according to how well it contributes to productivity, stable public finances but also employment, unemployment and trust in the future. It is very well done considering the first criteria, but is it possible to be as positive considering the latter ones?

Sweden's level of unemployment is lower than in the surrounding world and the employment is higher – so far so good. During the latest recession, the employment has not developed better than abroad, i.e. Swedish economy is equally affected by declining demand as any other country. Sweden has not been able to increase the employment rate. The economic framework thus does not give us an employment rate high enough. Our interpretation is that the Swedish framework no longer fulfils even moderate demands on Keynesian policy. It does give stability in public finances, but not enough stability in employment.

It should be a good argument for the present order if the framework also meant that the trust of the citizens towards the financing of the welfare system in the longer run was solid or strengthened. The idea with Sweden's ambitious surplus targets is that this will increase the possible consumption in the future. The government's fiscal policy is based on the bold condition that surpluses today will give space to borrow for consumption during several decades in the future.

But is this a trustworthy policy? Is it reasonable that the sick- and healthcare of the great number of persons born in the 1940's should be financed by loans, so that this substantially restricts the welfare of the persons born during the 1960's and 70's when they will need it? Apart from this, a repayment of the public debt today only means an increase in possible consumption of 1 per cent. If the tight fiscal policy limits employment in short term or limits the investments, it is not a good deal.

A balance target which means a repayment of the public debt with 2 per cent a year gives after 20 years, and with a public debt of 60 per cent of GDP, a space for consumption of 1,5 per cent of GDP. The fast repayment of the public debt thus does not widen the possible consumption more than this. 100 000 more people employed means in the term of 20 years, that the public sector should have about the same space for reforms as if the public debt should be yearly repaid with 2 per cent of GDP.

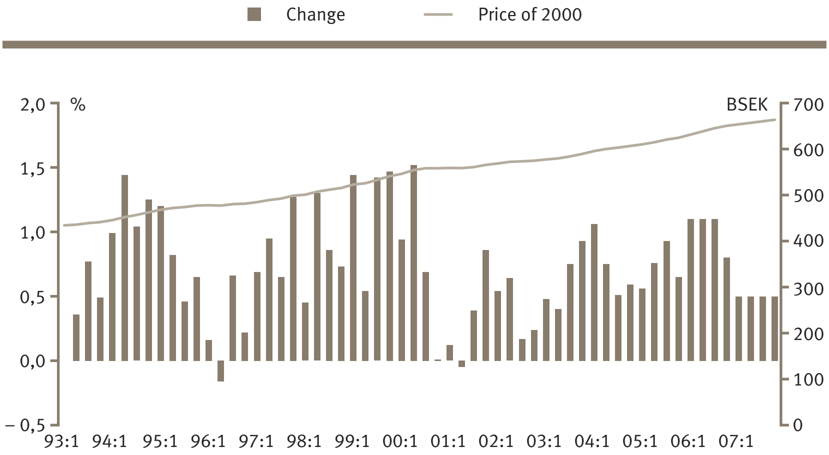
Sweden has a current account surplus of 8 per cent of GDP, i.e. consumption and investments are that much lower than production. Probably, Sweden is not investing enough in housing, hospitals and municipal infrastructure. The general pension funds are for example investing in municipal complexes in UK but not in Sweden.

We are interpreting the extreme level of financial saving within the private sector as if there is insecurity about the future. One could name this a trap of mistrust. The state is constructing a surplus for the future, but so are the households. We do know that the households want to increase their security in the long term. And this is done by forming financial assets to be able to consume more later on. If the private saving is going to decrease and the willingness to consume is to increase, the subventions for security savings could be suspended. But more security could also be offered to households, so they believe that future consumption of health and elder care or pension expenses are financed in such a way that they can save less than they do today. It seems in other words to be time for social engineering.

The public savings are not shaped so as to give households confidence in that future health care and eldercare are reasonably financed. This means that both households and the state are saving for the future but without the public saving giving positive effects on trust of the welfare state. Assurance solutions should be found which increase the trust in the welfare state and decrease the households' need to save.

Appendix: Key indicators

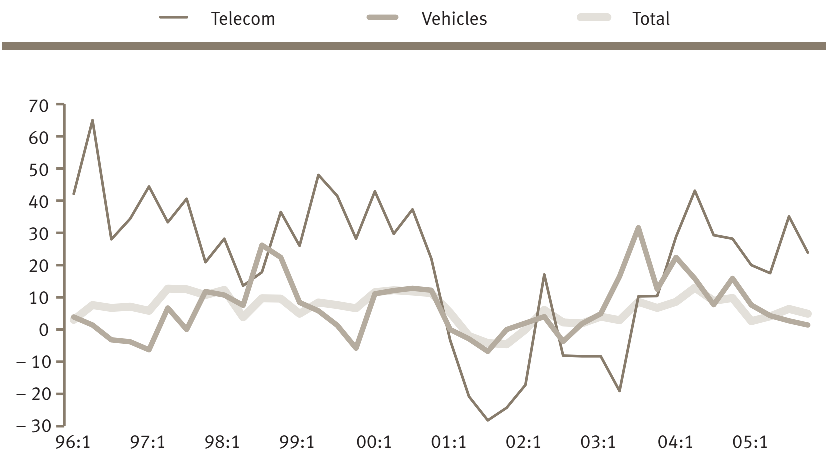
GDP. Seasonally adjusted quarterly values



Source: SCB and own calculations.

Chart 3

Volume of exports. Annual percent change

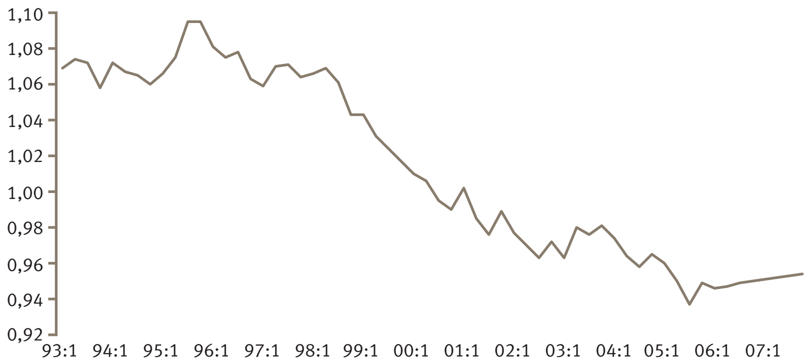


Source: SCB.

Chart 4

Terms of trade

Index 2000 = 1

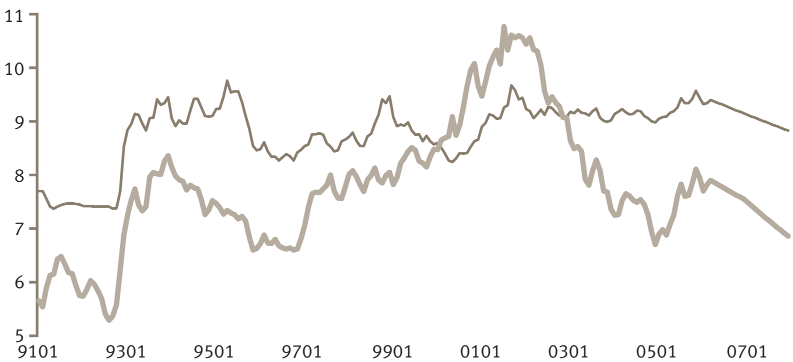


Source: SCB and own calculations.

Chart 5

Swedish exchange rates

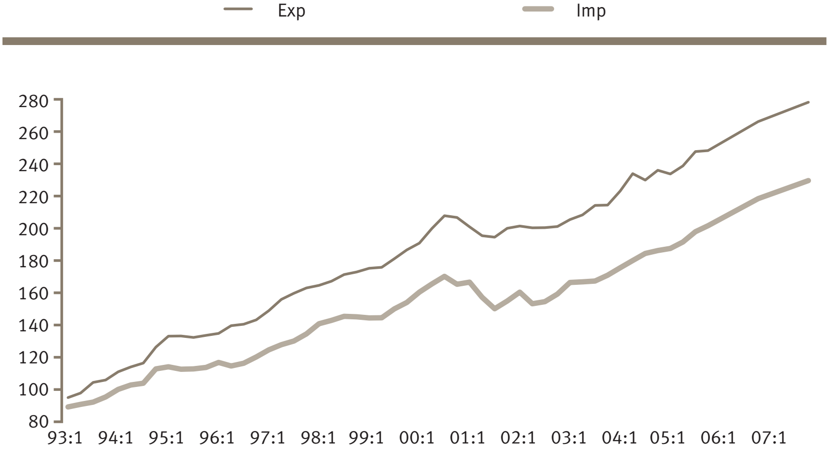
SEK/EUR SEK/USD



Source: RB and own calculations.

Chart 6

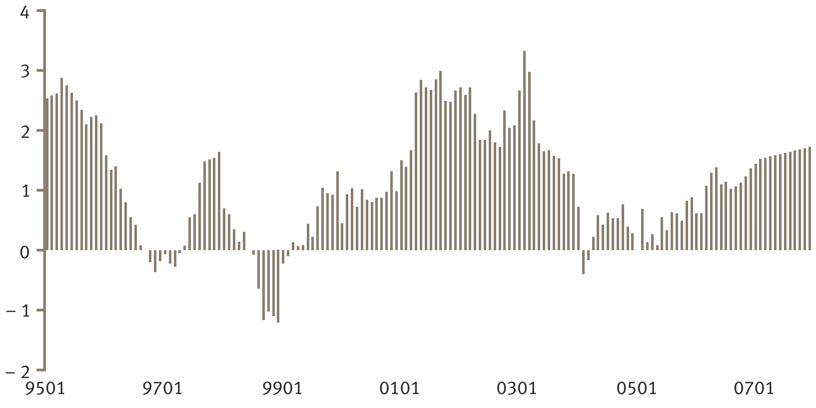
Trade with goods. Seasonally adjusted quarterly values, prices of 2000, BSEK



Source: SCB and own calculations.

Chart 7

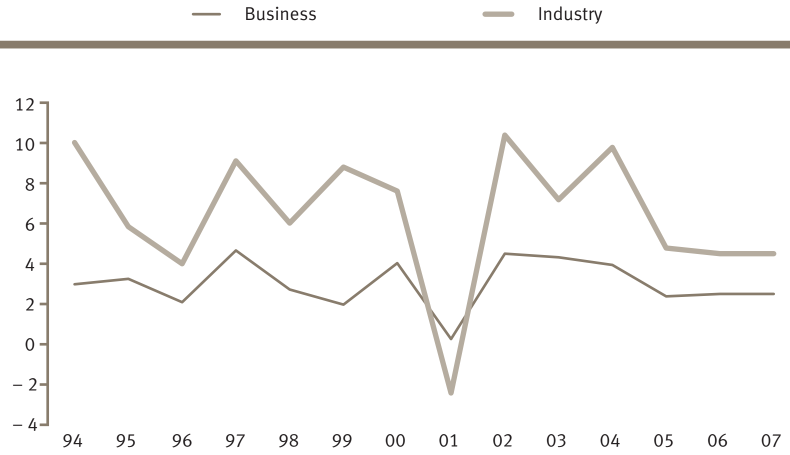
Consumer price index. Annual percent change



Source: SCB and own calculations.

Chart 8

Productivity. Annual percent change

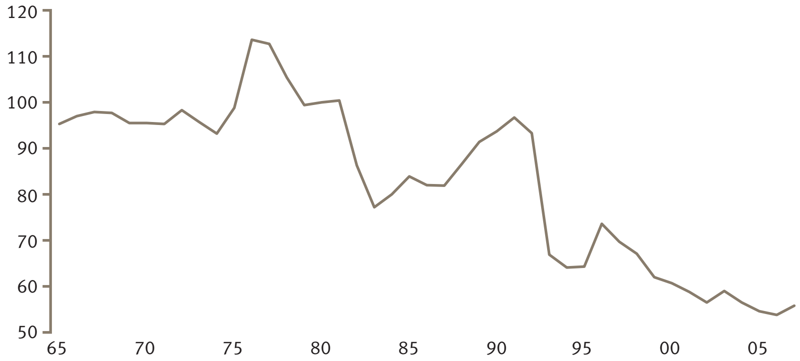


Source: SCB and own calculations.

Chart 9

RULC at the export market

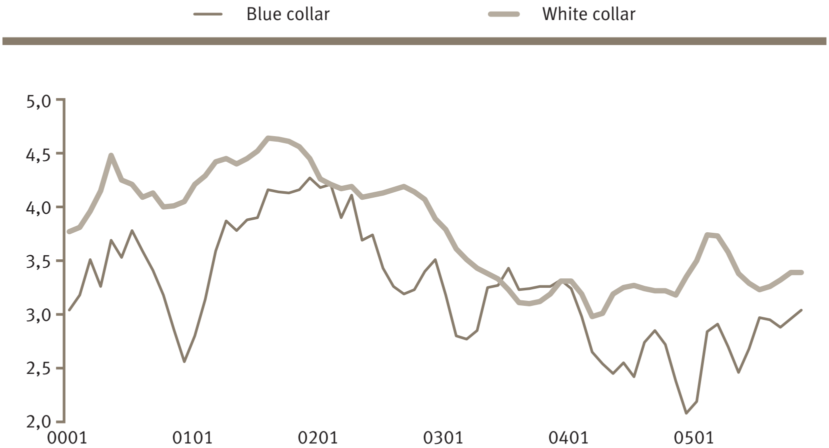
Index 1980 = 100



Source: SCB and own calculations.

Chart 10

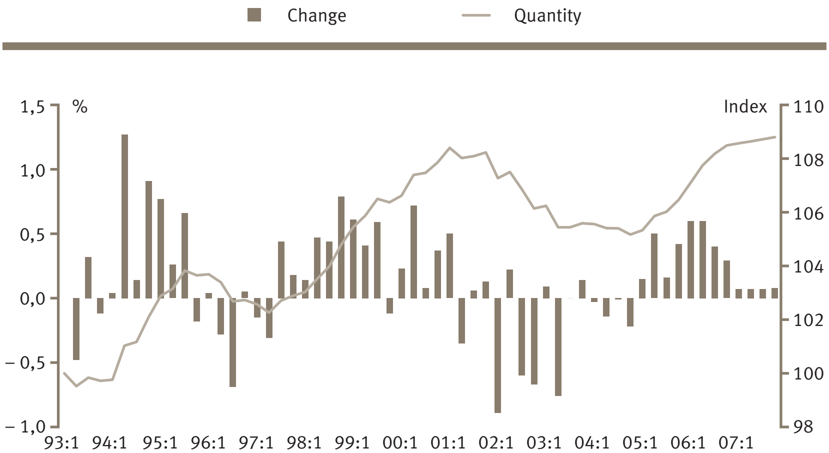
Wage increases in private sector. Percent, 3 months drifting



Source: Medlingsinstitutet and own calculations.

Chart 11

Hours worked. Seasonally adjusted quarterly terms



Source: SCB and own calculations.

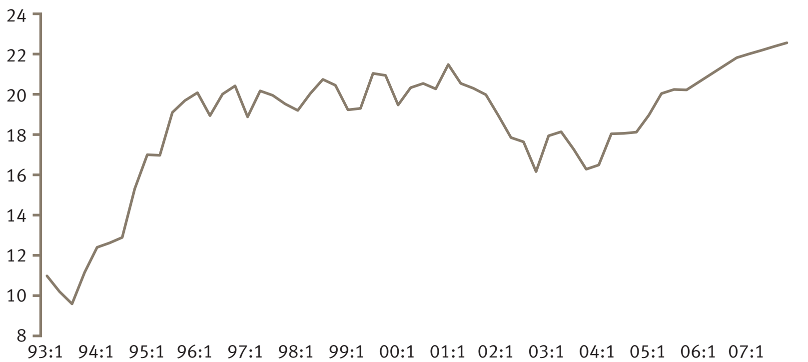
Chart 12

Profit share

Source: SCB and own calculations.

Chart 13

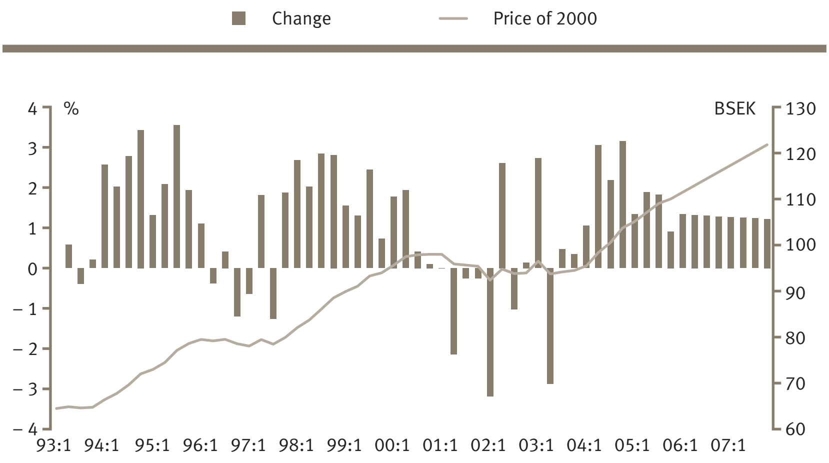
Investment in industry. Seasonally adjusted quarterly values, prices of 2000, BSEK



Source: SCB and own calculations.

Chart 14

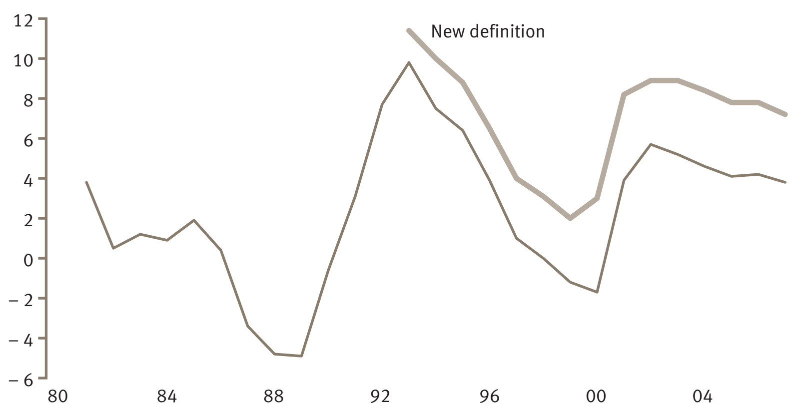
Gross fixed capital formation. Seasonally adjusted quarterly terms



Source: SCB and own calculations.

Chart 15

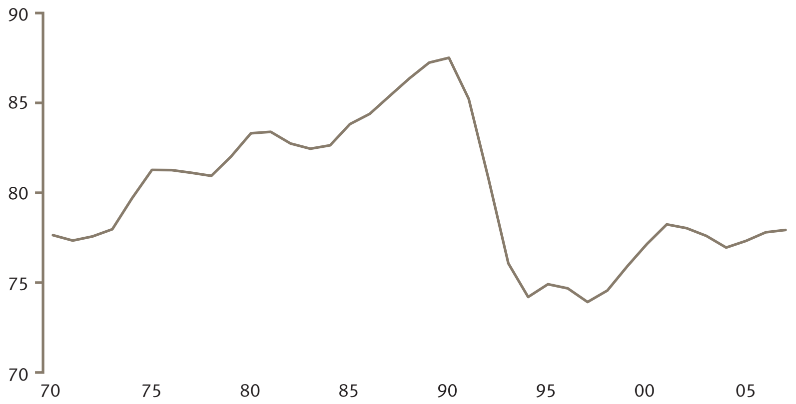
Household saving ratio. Percent



Source: SCB and own calculations.

Chart 16

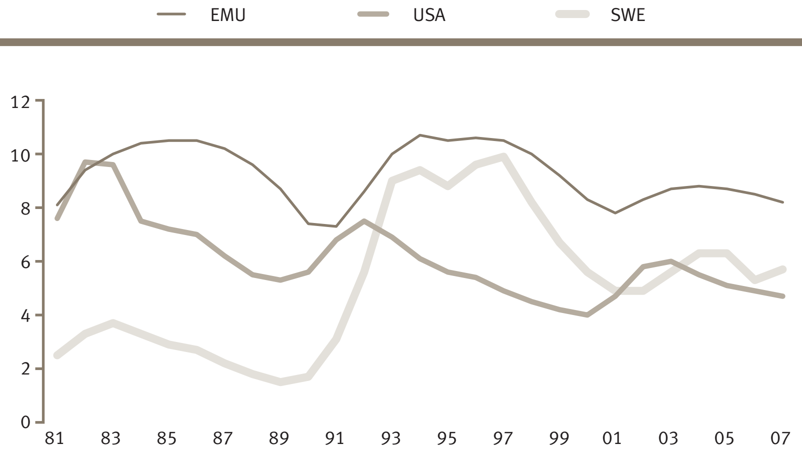
Employment rate 20–54 yrs old. Percent



Source: SCB and own calculations.

Chart 17

Standardised unemployment



Source: OECD, SCB and own calculations.

Chart 18

THE SWEDISH MODEL is not a steady state. The “model” is adjusted according to changing preconditions, but the aim to combine high growth and employment rates with a sustainable social development remains the same. This report gives a brief description of today’s Swedish model and notably the economic policy regime.

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