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CESIFO WORKING PAPER NO. 3790
CATEGORY 6: FISCAL POLICY, MACROECONOMICS AND GROWTH
APRIL 2012

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CESifo *Working Paper No. 3790*

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Abstract

Major economic reforms have been carried through in Sweden during the last two decades. Most of the reforms have been made in response to long-standing rather than to acute problems. There has usually been a strong perception among economists, policy makers and the general public of the problems that the reforms have sought to address. Reforms in other countries have sometimes provided inspiration. Most of the reforms were based on a broad political consensus. A heavy input from economic research has often been used as a basis for change.

JEL-Code: E660.

Keywords: economic reforms, political economy, deregulations, tax reform, labour market reforms, fiscal framework.

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I am grateful to Mounir Karadja for research assistance, to Harald Edquist, Sara Jonsson, Anna Larsson, Luca Paolazzi and Ulrika Stavlöt for helpful comments, to Christina Lönnblad for language editing, and to Astrid Wåke for secretarial assistance. The paper has appeared in “Cambia Italia. Come fare le riforme e tornare crescere” published by the publishing house S.I.P.I. SpA and is reproduced here with the express authorisation of the Editor.

1 Introduction

Sweden has recently come to be seen as an example of macroeconomic success. This largely reflects the strong public finances which place Sweden in a very different situation than most other EU countries. But there was also only a limited deterioration in labour market conditions in 2009-2010 and output as well as employment picked up more quickly than in most other European countries after the downturn. Taking a more long-term outlook, output has grown faster in Sweden than in the euro area over the last fifteen years.

The recent macroeconomic success of Sweden stands in stark contrast to the situation in the early 1990's. Sweden then suffered a deep economic crisis, with large falls in output and employment and soaring government deficits, much like the current situation in, for example, Ireland and Spain. This crisis came on top of a long period of stagnating growth in the 1970's and 1980's. Hence, in the mid-1990's, Sweden was considered to be a macroeconomic failure.

Over the last two decades, fundamental economic reforms have been undertaken in Sweden. They are likely to have contributed to the progression from macroeconomic failure to macroeconomic success. This paper surveys these reforms and analyses how they came about.

The discussion is structured as follows. Section 2 gives a brief review of macroeconomic developments, whereas Section 3 surveys the main reforms. Section 4 analyses what factors made the reforms possible and how they were carried through. Section 5, finally, tries to draw some general lessons for other countries.

Major economic reforms in Sweden have encompassed comprehensive tax reform, deregulation of product and service markets, reform of the wage-bargaining process, the establishment of a stricter fiscal framework, changes in the monetary regime and general labour market reforms. The Swedish experiences only provide limited support for the view that a deep economic crisis is a prerequisite for fundamental reforms. Instead, most of the reforms have been made in response to long-standing problems rather than to acute problems. However, some of the reforms were facilitated by EU accession, which was arguably triggered by the deep economic crisis in the first half of the 1990's. In most cases, there has been a strong perception among economists, policy makers and the general public of the problems that the reforms have sought to address. Reforms in other countries have provided inspiration in several cases. Most of the reforms have been based on a broad political consensus. A specific feature of Swedish decision-making on reforms has been the frequent use of heavy input from economic research as a basis for change.

2 Macroeconomic developments

Table 1 shows that average annual GDP growth in Sweden was 0.8 percentage points higher in 1995-2011 than in 1970-1994: 2.7 per cent versus 1.9 per cent. Average GDP growth in 1995-2011 was also considerably higher in Sweden than in the eurozone (EU-12): the difference was one percentage point. This is in contrast to the 1970-1994 period, when output growth was instead almost one percentage point lower in Sweden than in the euro area. The table also shows that the improvement in Swedish growth performance was mainly due to faster productivity growth.

Table 1

Figure 1 illustrates that the favourable Swedish growth record over the last fifteen years has been associated with a falling government debt-to-GDP ratio. This, in turn, reflects government budget surpluses in most of the time period since 1998, as can be seen from Figure 2. Even in the recession year 2009, the fiscal deficit was as small as 0.7 per cent of GDP. In 2011, there was a small fiscal surplus.

Figure 1

Figure 2

There is a strong contrast between the recent macroeconomic developments in Sweden and the situation in the first half of the 1990's. Sweden then suffered a deep economic recession. Credit market deregulations in the mid 1980's were followed by a rapid credit expansion, which led to a real estate price bubble. The bubble burst in the early 1990's, which caused a serious banking crisis coinciding with an international downturn. The large real appreciation that had taken place during the preceding boom when wages and prices rose faster than abroad, while the exchange rate was held fixed (first to a currency basket and then to the ecu), contributed to a fall in exports. The result was a deep recession, with GDP falls in three consecutive years 1991-1993 (in total around five per cent; see Figure 3). Unemployment rose from two percent in 1990 to levels of 10-11 per cent in 1993-1997 (Figure 4) at the same time as the employment rate (the ratio of employment to the working-age population) fell from 83 to 72-73 per cent (Figure 5). The result for public finances was a deficit as large as 11.2 per cent of GDP in 1993.

Figure 3

Figure 4

Figure 5

A distressing fact is that, despite the turnaround of the Swedish economy in the mid-1990's with subsequently higher output growth, the deterioration in the labour market in the early 1990's has not been fully reversed. As is clear from Figures 4 and 5, unemployment has remained considerably above and employment considerably below the levels achieved in the 1980's, which suggests that part of the initially cyclical unemployment in the 1990's crisis gradually turned structural through various persistence mechanisms.

3 A survey of reforms

When trying to explain the favourable output developments in Sweden after the 1990's crisis, one has to distinguish between the immediate recovery phase after the recession and the longer-term increase in the growth rate. The paper focuses on reforms with growth-enhancing effects over a longer period of time, but the picture would be incomplete without initially discussing the recovery phase after the acute crisis.

3.1 The depreciation of the *krona* and the recovery after the 1991-1993 recession

Naturally, the higher growth immediately after the recession in 1991-1993 mainly represents a normal recovery phase. However, a crucial factor for the swift recovery was the large *real exchange rate depreciation* that took place (see Figure 6). Between 1991 and 1993, relative unit labour costs decreased by 20 per cent. The main explanation was a *nominal* exchange rate depreciation of around 17 per cent. This reversed the real exchange rate appreciation that occurred in the 1980's.

Figure 6

During the first half of the 1990's, Sweden found itself in a sovereign debt crisis with large interest rate differentials to Germany, quite similar to the current situation of several eurozone countries. The debt crisis made a harsh fiscal consolidation necessary, involving both reductions in government expenditure and tax rises, starting in 1993/94. The real exchange rate depreciation gave a boost to net exports and made it possible for output to grow despite the fiscal restraint. This is illustrated in Figure 7, which shows real output growth, net export growth and the change in the structural fiscal balance (as a measure of the fiscal consolidation efforts).

Figure 7

Thus, Sweden provides a vivid illustration of the importance of swift real exchange rate depreciations for economies caught up in a situation with large fiscal deficits, low output growth and an appreciated real exchange rate. Without a real exchange rate depreciation, tax rises and government expenditure cuts are bound to reduce aggregate demand and output. Hence, tax revenues will fall and the fiscal consolidation will be very slow. This is the current predicament of the most crisis-ridden euro countries. They are not able, as was Sweden in the 1990's, to achieve export-led growth in the short run, since a large real exchange rate depreciation within the eurozone requires a fall in nominal labour costs, which can only be achieved after a lengthy period of high unemployment.

3.2 Economic reforms and longer-term growth

Although the large currency depreciation in 1992 started off a process with higher growth, it is highly implausible that the effects would last as long as fifteen years or more. In the twenty-year period before the floating of the Swedish *krona* in 1992, there were several devaluations which all failed to trigger such a process. Instead, the Swedish economy was then caught in a *devaluation cycle,* where each devaluation triggered a few years of high growth until wages caught up again and then overshot, leading to a real appreciation, which had to be corrected through a new devaluation etc.

The Swedish ”growth miracle” after 1995 has been widely discussed. Three major explanations have been suggested: (1) economic reforms; (2) large ICT investment; and (3) large R&D expenditures and investment in “intangible assets”.[1] Although there is no consensus on the relative importance of these factors and how they are interrelated, it is a widely held view that the economic reforms have been important. This is taken as the starting point for the discussion here. One can point to a number of reforms that are likely to have had growth-enhancing effects or to have such effects in the future. These include:

- Tax reform
- Deregulations of product and service markets
- Reforms of wage bargaining
- A new fiscal framework
- A new monetary-policy framework

[1] See, for example, EEAG (2007) and Edquist (2011).

- General labour market reforms

Comprehensive tax reform in 1990/91

The tax system had developed into a socially very inefficient one in the 1970's and 1980's. The marginal tax rates were high, distorting the labour/leisure choice as well as encouraging untaxed household work and work in the black sector. In the late 1980's, the highest marginal income tax rate was 73 per cent. The average *total* marginal tax wedge on labour (taking all taxes and benefits into account) was estimated to a similar figure. At the same time, many exceptions and deduction possibilities meant a large scope for tax planning and evasion. Another major deficiency was that more than 40 per cent of private consumption was fully or partly exempt from VAT. Asymmetries in capital income taxation favoured investment in housing and consumer durables at the expense of investment in the business sector.[2]

In 1990/91, there was a comprehensive tax reform. The reform is one of the most radical ones made in any advanced economy in recent decades. It was labelled "the tax reform of the century" in the Swedish debate. The guiding principles behind the reform were *uniformity* and *neutrality*. Uniformity implied that economically equivalent incomes should be taxed in the same way. Neutrality meant that the options available to households and firms should to as large an extent as possible be independent of taxation. These principles led to a significant broadening of the tax base, which made it possible to reduce statutory tax rates. Hence, there was a double dividend from the reform: the broadening of the tax base in itself eliminated inefficient asymmetries and the lowering of (marginal) tax rates reduced the differences between social and private returns.

The main elements of the tax reform were:

- A reduction of marginal tax rates on income from labour. The highest marginal tax rate on earned income was reduced from 73 to 51 per cent. According to one calculation, the total average marginal tax wedge for employees fell by 10 percentage points: from 73 to 63 per cent.
- The VAT was extended to more areas and a uniform VAT rate was imposed.
- A *dual* income tax system, distinguishing between capital and labour income, was introduced. Labour income taxation remained progressive (though less so than before the reform), whereas a low proportional rate (30 per cent) was applied to capital

[2] See, for example, Agell, Englund and Södersten (1995) and Fiscal Policy Council (2011).

income. The motivation for the low capital income tax is that it is levied on nominal instead of real returns. The same tax rates were applied to all forms of capital incomes (including capital gains on property) as well as to interest deductions on loans, which eliminated the earlier asymmetries favouring housing investment.

- Corporate taxation was lowered (to 30 per cent) at the same time as various reservation possibilities, limiting tax payments, were abolished.

Evaluations of the tax reform have indicated considerable social welfare gains in the form of improved resource allocation from the reductions of tax distortions that were made.[3] One of the aims was that the reform should produce a *stable* tax system for the future. This has, however, only held partly. There has been a large number of subsequent changes. Many of these clearly reduce the social efficiency of the tax system. They include an income tax surcharge for the highest income earners, raising their marginal income tax rate by five percentage points. Other efficiency-decreasing deviations from the tax reform are the introduction of multiple VAT rates (without any relation to optimal taxation concerns), lower payroll tax rates for young people and an abolition of the real estate tax. Some changes, such as the recent introduction of an earned income tax credit and a tax deduction for household services (see the discussion of labour market reforms below), are instead welfare-increasing. On the whole, the major part of the social efficiency gains from the 1990/91 tax reform remain, although they have to some extent been diluted.[4]

Deregulations of product and service markets

Starting in the late 1980's, there have been extensive deregulations of product and service markets strengthening competition. The main changes are:

- Deregulations, mainly in the first half of the 1990's, of several *network industries* that were earlier shielded from competition: air traffic, telecommunications, electricity generation and distribution, postal services, railway and other transport, and taxi services. The deregulations have eliminated or significantly lowered the legal barriers to entry.
- Stricter competition legislation, prohibiting all forms of cartels and price co-operation among firms in line with EU legislation, in 1992. Earlier, cartels and price

[3] Ibid.
[4] Sörensen (2010) and Fiscal Policy Council (2011).

cooperation were allowed, provided that they could not be shown to have any harmful effects.

- Large privatisations of state-run companies starting in 1989 and then proceeding over time. The privatisations have involved companies in a large number of areas: steel production, telecommunications, banking, forestry, medicine, production of liquor etc.
- Legal changes in 1992 requiring municipalities, in their zoning decisions, to pay greater attention to the objective of stimulating competition in retailing. Earlier, municipalities often stopped new start-ups in order to shield existing retail businesses from competition. After the legal changes, it has, for example, become much easier to establish new supermarkets outside the city centres.
- Greater freedom since the early 1990's for local governments (municipalities and counties) to outsource the production of the welfare services for which they are responsible (old age care, care of disabled, health care, family welfare, child care and schools) to private providers. The private providers' share of total employment in such services has risen from around 11 per cent in 2002/03 to around 17 per cent in 2010.[5]

In addition, Sweden's EU entry in 1995 opened up food processing, which was earlier a low-productivity sector by Swedish standards, to foreign (European) competition. This is likely to have contributed to the recent fast productivity growth in this sector.[6] The EU entry also opened up the banking sector to more foreign competition, at the same time as the entry barriers were also lowered for domestic competitors (making it easier to obtain banking licences).

It is well-established in international research that competition-enhancing deregulations in product and service markets stimulate productivity growth.[7] This occurs through several mechanisms: lower barriers to entry, more efficient resource allocation, stronger incentives to innovate and faster diffusion of new technology. Studies of Sweden have usually reached similar conclusions.[8] However, in an international comparison, Sweden does not stand out as

[5] Hartman (2011). The cited figures exclude health care.
[6] McKinsey (2006).
[7] See, for example, Wölfl, Wanner, Kozluk and Nicoletti (2010).
[8] See OECD (2004), *Regelutredningen* (2005) and Fölster and Peltzman (2006) for surveys. An exception is Hartman (2011), where it is concluded that so far there exists no scientific basis for gauging the productivity effects of the opening up of welfare services financed by local governments for competition from private providers.

a country with extraordinarily large deregulations. According to Figure 8, which shows the OECD's indicator of aggregate product market regulation, Sweden finds itself in a middle group in terms of level in 2008 and the change over the 1998-2008 period has been below average. (However, the aggregate indicator hides that Sweden has relatively low barriers to entrepreneurship but a relatively large degree of state control). The quoted aggregate product regulation indicator does not exist for the years before 1998, but another OECD indicator only focusing on network industries, starting already in 1982, does not show any above-average deregulations in Sweden either.[9] There is, however, one main difference between Sweden and the majority of EU countries: Sweden was earlier in making major deregulations of network industries (already in the first half of the 1990's).

Figure 8

Reforms of wage bargaining

Collective bargaining plays a key role for wage setting in Sweden. In 2009, 90 per cent of the employees were covered by collective agreements, 71 per cent of the employees were organised in trade unions and 75 per cent of the private-sector employees worked in firms belonging to an employers' association.[10] Wage bargaining used to be highly centralised: in the 1950's and 1960's, economy-wide wage increases were negotiated centrally between the Swedish Employers’ Confederation and the Trade Union Confederation (organising blue-collar workers). This system started to crumble in the 1970's when wage negotiations for both private-sector white-collar workers and public-sector employees began living lives of their own outside the earlier centralisation.

The earlier centralised bargaining for private-sector blue-collar workers gradually broke down during the 1980’s and was replaced by uncoordinated industry-level bargaining. The process was driven by dissatisfaction on both the employer and (part of) the union side with the far-reaching wage compression produced by the earlier bargaining system: employers in general desired more individual wage setting (enhancing incentives for individual effort) and unions in the engineering sector wanted to raise their relative wages. In addition, employers felt that the earlier centralised system gave the Trade Union Confederation too large a political weight.

[9] See Nicoletti and Scarpetta (2005), EEAG (2007) and SNS (2007).
[10] *Medlingsinstitutet* (2011).

According to the *Calmfors-Driffill hump-shape hypothesis*, intermediate, industry-level bargaining is the form of collective bargaining that is least conducive to wage restraint.[11] Both highly coordinated wage bargaining and decentralised firm-level bargaining deliver more wage moderation: highly coordinated bargaining because wage setters are forced to make economy-wide considerations, decentralised bargaining because wage setters have to take competitive pressures into account. This hypothesis seemed to be borne out by high wage increases in Sweden in the 1980's.

In the early 1990's, employers and trade unions had conflicting ideas of how the bargaining system ought to develop. Employers pressed for moving to a system of firm-level bargaining, whereas (the majority of) unions wanted a return to centralised bargaining. The stalemate was solved in 1997 by the conclusion of the so-called *Industry agreement* on bargaining procedures between a number of employers' associations and trade unions in the manufacturing sector. The agreement envisaged a system with continued industry-level bargaining, but where there would be strong *informal coordination* based on pattern bargaining with the manufacturing sector (in practice the engineering sector encompassing production of electrical and other machinery, motor vehicles, telecom equipment etc.) concluding the first wage agreements in a bargaining round, thus establishing a norm for wage increases for others to follow. This bargaining set-up was agreed between the parties in the labour market without any government involvement, but it was backed up in 2000 by the creation of a *National Mediation Office* which has as one of its tasks to support the norm-setting role of "the sector exposed to international competition", that is the manufacturing sector.[12]

Figure 9

The reformed bargaining system has turned out to be consistent with lower nominal wage increases than in the past (Figure 9). At the same time, it has allowed more individual wage flexibility. The importance of guaranteed individual wage increases in the industry-level agreements has decreased. In 2010, local-level agreements could influence the distribution of wage increases among individuals at the workplace for 94 per cent of the employees. For 40 per cent of the employees, there were no constraints at all from the industry-level

[11] Calmfors and Driffill (1988). See also Calmfors (1993, 2001) and EEAG (2004).
[12] See Calmfors and Larsson (2011) and *Medlingsinstitutet* (2011).

agreements on how wage increases are distributed among individuals.[13] This development has made it possible to relate individual wages to individual productivity to a much larger extent than earlier. This is a likely explanation of the increase in wage dispersion, especially at the top of the wage distribution, which has taken place (Figure 10).

Figure 10

Reforms of the fiscal framework

The fiscal consolidation in the 1990's, which was described in Section 2, was followed up by the establishment of a new, stricter fiscal framework. The main reforms were made towards the end of the 1990's, but there have also been more recent amendments. The reformed framework consists of the following pillars:

1. A *top-down approach* for the adoption of the budget in Parliament. Decisions are taken in *two steps*. In a first step, Parliament decides on overall expenditure and its allocation between 27 expenditure areas. In a second step, decisions are taken on individual expenditure items. In this phase, an expenditure item cannot be increased unless another expenditure item in the same area is correspondingly reduced.
2. A *surplus target* according to which general government net lending should be one per cent of GDP. To preserve flexibility for fiscal policy, the target does not apply to each year but *over a business cycle*. However, the government makes no attempts to date the cycle. Instead, it evaluates adherence to the target with the help of several indicators: a backward-looking average of actual net lending, a – partly – forward-looking average of actual net lending, and cyclically adjusted net lending (for both individual years and longer time periods). Initially, the surplus target was not stipulated in the budget law, but it was included from 2010.
3. A *ceiling* for *central government expenditure* set at least three years in advance. The ceiling applies to all central government expenditures except interest payments. Initially, it was not mandatory for the government to propose an expenditure ceiling, although there were regulations for how it should be used if it were decided (which it has been for every year since 1997). The stipulations require the government to take action if the ceiling is in danger of being breached. In 2009, it became mandatory for the government to propose an expenditure ceiling to Parliament.

[13] *Medlingsinstitutet* (2011).

4. A *balanced budget requirement* for *local governments*. They must budget for an excess of revenues over expenditures. If there is a deficit ex post, it must be compensated for by a surplus within three years.
5. A *pension system* designed to guarantee long-term sustainability as contributions, not benefits, are defined. The system contains a *balancing mechanism* which automatically reduces pensions if the long-run financial stability of the pension system is threatened: this occurs if the capitalised value of contributions plus the assets in the buffer funds fall below the value of pension liabilities. There is no legislated retirement age, only a minimum age of 61. The retirement decision is instead left to the individual on basis of the incentives in the system, which is basically actuarial with later retirement giving a higher pension.[14]
6. A system for monitoring fiscal developments by a number of government agencies.[15] The latest addition to these institutions is an independent *Fiscal Policy Council,* set up in 2007, with the remit of monitoring that fiscal policy is sustainable and consistent with the fiscal rules.

Despite the fact that there are no formal enforcement mechanisms, the respect for the fiscal rules has been high. The surplus target of one per cent of GDP over a business cycle has been observed. The central government expenditure ceiling has never been violated, although this has sometimes required some *creative accounting*. Such manipulations have, however, been rare. The expenditure ceiling has been set so as to give a trajectory where both government expenditures and taxes have fallen over time relative to GDP (Figure 11). The balanced budget requirement for local governments has been respected even though there are no sanction mechanisms in the case of breaches. The likely explanation for why the fiscal rules have been observed is that the experiences of the fiscal crisis in the 1990's imply that violations would carry high reputation costs for policy makers.

Figure 11

Fiscal discipline contributes to long-term output growth by helping to hold down real interest rates. It also helps avoid situations where drastic budget consolidations become necessary with serious output losses at least in the medium term as a consequence. There is a very clear link between pension rules and labour force participation/employment. Figure 12 shows that

[14] See EEAG (2007), Palme and Svensson (2007) and Fiscal Policy Council (2009, 2010).
[15] See Calmfors (2011a,b) and Calmfors and Wren-Lewis (2011).

the earlier trends towards a falling effective retirement age and a falling ratio between the effective retirement age and life expectancy were broken in the late 1990's (when the new pension rules began to be phased in) and replaced by what looks like the beginning of rising trends.

Figure 12

Inflation targeting and central bank independence

Also after the break-down of the Bretton-Woods currency system in 1973, Sweden tried to pursue a policy of fixed exchange rates: first against the D-mark, then against a trade-weighted currency basket and finally against the ecu. The idea was that the fixed exchange rate should anchor inflation. This policy did not work. Instead, as discussed above, between 1973 and 1992, Sweden was caught in a devaluation cycle, with high inflation leading to a devaluation, triggering new inflation, leading to a new devaluation etc.

During the deep recession in the early 1990's, the central bank was not able to defend the fixed exchange rate and instead of a devaluation chose to let the *krona* float freely (in 1992). To anchor inflation, the central bank on its own decided on an *inflation target* of two per cent per year. The target was later confirmed by Parliament. The central bank has been successful in keeping down inflation, in fact often too successful as there has on average been undershooting of the target (Figure 13). Another crucial monetary regime change was when the earlier politically dependent central bank was made independent from the political system in 1999.

Figure 13

The dichotomy between monetary and real variables has been a key tenet of macroeconomic theory. In this vein, monetary policy is not believed to affect real variables, like output and employment, in the long run, only in the short run. Recent macroeconomic theory holds, however, that *monetary regimes* may have real effects. More precisely, a conservative central bank, putting large emphasis on price stability, may act as a deterrent to high wage increases in a collective bargaining system with only intermediate coordination: any large trade union or large employers' association is likely to realise that if it negotiates a large wage increase that raises the aggregate price level, a conservative and independent central bank will react with interest rate hikes hurting output, employment and profits. Hence, a credible inflation-targeting regime in a country like Sweden may promote high output and employment.[16]

Late, but comprehensive, general labour market reforms

The late 1990's saw reforms of wage-bargaining practices carried out mainly by the parties in the labour market. General labour market reforms involving changes in various government-run systems have been late in coming in Sweden. The 1990's saw some reductions in unemployment benefits, but these reductions were later reversed. The huge active labour market programmes during the 1990's crisis – which peaked at around 5 per cent of the labour force in subsidised employment and labour market training – were also cut back substantially (both in absolute terms and relative to open unemployment) when the business cycle turned up again. However, in 2006 the incoming Liberal-Conservative government embarked on a comprehensive reform programme. The main ingredients were:

- The introduction of an *earned income tax credit*, lowering the taxation of income from employment but not that of income from transfers and benefits. The credit was introduced in 2007 and has been expanded three times since then.
- A reduction in the generosity of the *unemployment insurance.* According to the new rules, the benefit level for an unemployed individual falls over time. Participation in a labour market programme no longer requalifies an unemployed individual for a high benefit. The access to unemployment benefits for labour market entrants has been restricted.
- The funding of the unemployment insurance has been reformed by linking employee contributions in different sectors to the costs for unemployment benefits in the respective sectors.
- Tax deductions for union membership fees and government subsidies to unions have been cancelled.
- Active labour market policy has been reoriented from subsidised employment and labour market training to more of job search and matching activities. Employment services have been opened up for competition from private providers.
- A tax rebate on purchases of household-related services.

[16] Calmfors (2001) and Larsson (2007) survey this research literature. The described effect cannot arise for a country that has adopted the euro as long as bargaining in various sectors takes place at the *national* level, since each bargaining area is then too small to have an effect on aggregate inflation in the eurozone and hence on ECB policy.

- Payroll tax cuts for young people.
- Stricter rules for obtaining sickness benefits and early retirement. The work ability of a sickness benefit recipient is to be tested at pre-specified intervals. In principle, there is now a maximum period for obtaining a sickness benefit of 2 1/2 years, after which the work ability of the benefit recipient is to be tested by the Public Employment Service in a labour market introduction programme (with restricted possibilities of being transferred back to sickness insurance or of obtaining early retirement).

The combined effect of the earned income tax credit and the reduced unemployment benefits has been to increase the returns to work. As shown in Table 2, the *after-tax replacement rate* for unemployed individuals (the ratio between benefit income and earlier income from work) has fallen by 10-20 percentage points for large groups of wage earners between 2006 and 2010. Since these changes have coincided with a deep recession, it has been difficult to evaluate the effects: the supply-side effects are likely to have been swamped by aggregate demand developments. A recent study, however, estimated the effects on the wage level to be of the order of magnitude of four per cent, which suggests large effects on equilibrium (structural) employment.[17] Model calculations by the Ministry of Finance suggest that the labour market reforms will increase the employment rate (employment relative to population 15-74 years) by three percentage points and reduce the unemployment rate by 1.4 percentage points in the long run.[18]

Table 2

Figures 14 and 15 show that sickness absence and early retirement have recently fallen dramatically. Sickness absence has earlier been very high in Sweden. It has also developed procyclically, with absence increasing in good times and falling in bad times. This pattern was broken around 2005. For both sickness absence and early retirement, the earlier trends were reversed already before the reforms by the current Liberal-Conservative government. This probably reflected changed practices of the Social Insurance Agency.

Figure 14

Figure 15

[17] Bennmarker, Calmfors and Larsson (2011).
[18] Finansdepartementet (2011). See also Fiscal Policy Council (2011).

The swiftest effect of the labour market reforms is likely to be on labour force participation, which is less dependent on the economic cycle than employment. Figure 5 in Section 2 also showed that labour force participation held up very well during the recent recession.

4. How did the reforms come about and how were they carried through?

This section discusses the *political economy* of the Swedish reforms, that is how they came about and how they were carried through. The focus is on the following questions:

1. To what extent have the reforms been responses to long-standing problems and to what extent to acute crises?
2. How have the problems motivating the reforms been perceived by public opinion, by policy makers and by economic experts?
3. How important have international influences been and to what extent have reforms represented new thinking and to what extent a return to earlier principles?
4. Have the reforms been based on a political consensus or have they been carried through by the political majority against the will of the opposition?
5. How has the resistance from various vested interests been overcome?
6. Have the reforms had the character of shock therapy or have they been introduced gradually?

4.1 Responses to long-standing problems or to acute crises?

It is a common view that economic reforms are easier to implement in deep crises. This may be because both policy makers and voters are then more open to new thinking, as the failure of earlier policies is then often obvious. The benefits of overcoming vested interests also appear more evident. Some labour market reforms, such as reduced employment protection, may also be less controversial for employed insiders in a deep economic downturn as such rules offer little protection in such a situation. Indeed, also current insiders may then in a near future expect to gain from weaker employment protection, as they may then soon turn into unemployed outsiders whose hiring prospects improve with smaller firing costs for firms.[19] However, other labour market reforms, such as reductions of unemployment benefits, may be easier to implement in good times than in bad times because the political majority of employed insiders then face smaller unemployment risks.

[19] See Saint-Paul (1996) and EEAG (2004).

The Swedish case only offers limited support for the hypothesis that reforms are made primarily in response to acute crises. Several of the described reforms have instead been responses to long-standing problems. This was, in particular, the case with the "tax reform of the century" in 1990/91 which was decided well before the onset of the 1991-1993 recession. The tax reform can instead be seen as a response to the fall in output growth from the early 1970's and an increased awareness of the distortions created by the earlier tax system (see also Section 4.2). The first piecemeal reductions of marginal tax rates on labour income as well as on interest income (matched by reductions in the interest deductions) were decided already in 1982 and implemented in 1982-1985.

To the extent that product market deregulations were a response to perceived economic problems (see Section 4.3), they were also of a long-term nature rather than acute. As discussed above, the deregulation process started in the late 1980's already before the 1991-1993 recession.

The general labour market reforms by the current Liberal-Conservative government are also an example of changes in response to persistent rather than acute problems. The recession in the early 1990's triggered some reductions in the generosity of unemployment insurance. But these changes were mainly motivated by the need for fiscal consolidation and not by the objective of fighting unemployment. They were also reversed as soon as the fiscal problems became less pressing towards the second part of the 1990's. As discussed in Section 3.2, a comprehensive programme of labour market reforms was not initiated until in 2006/07. The motive given by the government was dissatisfaction with the fact that employment, more than a decade after the recession in the early 1990's, was still far below the earlier levels (see Figure 5).[20]

The reform most evidently in response to an acute crisis was the change in the monetary regime to a floating exchange rate and inflation targeting in 1992, which was forced by a full-blown currency crisis, where the central bank had exhausted its possibilities of defending the earlier fixed exchange rate. But the move to greater central bank independence in 1999 should rather be seen as a response to the failure to contain inflation throughout the whole 1974-1993 period (see also Section 4.2). When the central bank reform was carried out, inflation had already converged to the inflation target of two per cent (see Figure 13).

[20] Budget Bill 2007.

The establishment of the new fiscal framework in the latter half of the 1990's can be seen as a response to the fiscal crisis in the first half of the decade. But most of the changes came with a lag: a large part of the fiscal consolidation had already been accomplished when the new rules were introduced. The main exception was the pension reform which was decided already in 1994 and on which it would in all likelihood not have been possible to reach a political consensus (see Section 4.4) without the general concern for long-run fiscal sustainability that derived from the acute fiscal crisis at the time.

The reform of wage bargaining with the conclusion of the *Industry agreement* in 1997 (see Section 3.2) was triggered by dissatisfaction with the three-year wage agreements for 1995-1997: despite the then prevailing high unemployment, it was enough with only a small fall in it for wage increases to become higher again rise again (see Figure 9). However, the problems of insufficient incentives for wage moderation had already been at the centre of the macroeconomic policy debate for almost two decades before the reform.

The conclusion is that a majority of the economic reforms (tax reform, product market deregulations, general labour market reforms and the granting of independence to the central bank) were responses to long-standing problems rather than to acute crises. The move to a floating exchange rate combined with inflation targeting was, however, an immediate consequence of an exchange rate crisis. The reforms of the fiscal framework were a response to a sovereign debt crisis, but occurred with a lag. The reform of the bargaining system towards the end of the 1990's had unsatisfactory wage developments as its direct trigger, but the main explanation was the wage outcomes during the two preceding decades.

To get a more complete picture of the relative importance of acute crises and long-standing problems for the reforms, one must also discuss Sweden's accession to the EU, which occurred as late as 1995. As discussed in Section 4.3, EU membership has played an important role for some of the reforms. During the cold war, joining the EU was considered to be out of the question by a political majority, because it was seen as inconsistent with *neutrality* between NATO and the Warsaw Pact, a corner stone of Swedish foreign policy. This position was held most strongly by the Social Democrats, which was in power for most of the time (during the whole post-war period up till 1991 except in 1976-1982). But the Social Democrats suddenly abandoned this position and opened up for negotiations on EU membership as part of an economic crisis programme designed to bolster the credibility of the fixed exchange rate during an acute currency crisis in 1990.[21] Hence, one could claim that responses to an acute crisis played an important *indirect role* for later reforms by opening up for EU accession, which later on facilitated reforms to deal with long-standing problems.

4.2 The perception of the problems motivating the reforms

The next issue concerns the perceptions of the problems motivating the reforms in various segments of society. Here, it seems that in almost all cases, there was a widespread awareness of the problems.

The most clear-cut case is the comprehensive tax reform in 1990/91. For example, an ex post evaluation of the reform paints a picture of a general view in society of a failed tax system which encouraged black-sector activities, tax evasion and improductive investment and which, for this reason, was seen as redistributing income in an arbitrary fashion.[22] As a consequence, the tax system suffered serious problems of legitimacy. In a widely publicised article, the Swedish Nobel Prize laureate in economics Gunnar Myrdal described how the tax system was transforming Sweden into a "nation of fiddlers".[23] The tax reform was also preceded by several reform proposals from various think tanks and organisations during the 1980's.

There was also a widespread awareness in society of the problems that the establishment of a new fiscal framework, the changes in wage-bargaining practices and the labour market reforms were designed to solve. The many instances of interest rate hikes on government bonds during the fiscal crisis in the first half of the 1990's made fiscal discipline a key issue for both policy makers and the general public. The Liberal-Conservative government appointed an expert commission in 1993, the *Lindbeck Commission* (named after its chair,

[21] *Regeringens skrivelse* 1990/91:50. The importance of the acute crisis management for the Social Democratic government's decision to apply for EU membership is, however, a contentious issue. The then Prime Minister Ingvar Carlsson has vigorously disputed the view that the change in position was made in "a footnote in an economic crisis programme" and has instead painted a picture of a gradual softening of his and the Social Democratic party's attitude to the EU against the background of the dissolution of the Soviet bloc (Carlsson 2003). It seems evident, however, that any change in the position on EU membership was not clearly apprehended by the general public until the presentation of the crisis measures in October 1990.

[22] Agell, Englund and Södersten (1995).

[23] Myrdal (1978). An important role for increasing the awareness of both the arbitrariness and the social inefficiency of the earlier tax system was played by the famous author of children’s books, Astrid Lindgren, who in 1976 published a tale in a newspaper ridiculing a system with more than 100 per cent marginal tax rates which "entrepreneurs" like herself could be exposed to at the time (Lindgren 1976).

professor Assar Lindbeck), which came up with many of the proposals for a new fiscal framework that were later enacted.[24]

The reforms of wage bargaining in 1997 were made against the background of at least fifteen years of public debate on the failure of wage-bargaining institutions to deliver wage moderation, where especially the employer side was very active. The general labour market reforms starting in 2006/07 were preceded by a decade of debate on the risks of the initially cyclical unemployment in 1991-1993 becoming persistent. Academic economists, to a large extent influenced by advances in the theory of unemployment stressing the importance of labour market institutions for structural unemployment, played an important role in this debate.[25] It is unclear how large the direct impact was on public opinion. There was, however, a strong influence on a group of advisers to the Moderates (the Swedish Conservatives) who before the 2006 election formulated a radical package of labour market reforms, which was also adopted as the pre-election platform of the Liberal-Conservative alliance.[26] In the election campaign, this programme played a key role, being helped by general concerns about jobless growth in the then ongoing economic upturn. After the Liberal-Conservative Parties' election victory, with the Moderates emerging as the leading party of the new coalition government, this programme was implemented.

The reforms that were preceded by the least public discussion were the deregulations of product and service markets starting in the late 1980's. Neither the discussion among economists nor the general public discussion put much emphasis on these issues.

The move to a floating exchange rate and inflation targeting in the monetary policy field in 1992 was not preceded by much public discussion either. Almost all Swedish economists were, up until the point where the *krona* was allowed to float in November that year, strong defenders of a hard-currency option according to which a fixed exchange rate should serve as an anchor for price stability (labelled *norm policy* in Sweden).[27] Indeed, when an invited group of US economists from the Brookings institution wrote a report on the Swedish economy in 1987, advocating a floating exchange rate, this proposal was dismissed by most

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[24] *Ekonomikommissionen* (1993).

[25] Layard, Nickell and Jackman (1991) and Pissarides (1990) were two seminal contributions to the advances in the theory of structural unemployment. Calmfors and Forslund (1990), Holmlund (1996) and Calmfors and Holmlund (2000) are three examples of how this theory was applied to Sweden.

[26] *Alliansens valmanifest* (2006).

[27] See Calmfors (1996) and Jonung (1999).

Swedish economists.[28] However, the move to central bank independence in the late 1990's had been preceded by a long debate, where Swedish economists, being influenced both by the emerging research literature on time-inconsistency problems of monetary problems and the empirical success of countries with independent central banks (like Austria, Germany and Switzerland) to hold down inflation, were very active.[29] These proposals did not have any great impact on the general public, but they influenced many policy makers (especially on the Liberal-Conservative side). A government commission came up with a proposal to make the central bank independent from the political system in 1993.[30] Although this proposal was first dismissed by the Social Democratic government that took office in 1994, it constituted the basis for central bank reform when it was later decided in 1997.

4.3 New thinking and international influences or return to old principles?

Reforms can be of two types. They may represent new solutions because old methods have failed or they may represent a return to old principles that had (erroneously) been abandoned. The Swedish case provides examples of both types.

The deregulations of product and service markets, the tax reform, the monetary regime changes and the labour market reforms all reflect new thinking, representing a breach with earlier policy principles. *International influences* have been an important driving force in all these cases. This is most obvious with the product and service market deregulations and the privatisations.[31] As discussed in the previous section, these reforms were not preceded by long-time discussions. Instead, the main driver seems to have been the international trend towards such deregulations. The opening-up of network industries for competition and the privatisations in Sweden were to a large extent inspired by the earlier developments in especially the US and the UK. The need to adapt to EU competition legislation was another important driving force.

The "tax reform of the century" in 1990/91 also had international predecessors that provided some of the inspiration. Tax reforms with the aim of broadening tax bases, lowering statutory tax rates and achieving neutrality between different types of investments took place in many

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[28] Bosworth and Rivlin (1987).
[29] See, for example, SNS (1986, 1988).
[30] *Riksbanksutredningen* (1993).
[31] See, for example, McKinsey (2006) and SNS (2007).

countries in the 1980's although they were not as comprehensive as the Swedish one. In particular, the US tax reform of 1986 appears to have been influential.[32]

EU treaty obligations were used to motivate the granting of independence to the Swedish central bank in 1999. Somewhat paradoxically, an additional driver was the Swedish decision in 1997 to stay outside the EU monetary union: for example, the Government Commission on the EMU (the Calmfors Commission) had argued that an independent central bank was a prerequisite for a credible low-inflation policy if Sweden were not to join.[33] The choice of inflation targeting as the anchor for price stability was to a large extent modelled on New Zealand's monetary policy set-up, which had been established already in 1990.

The general labour market reforms from 2006 and onwards were helped by the fact that international organisations, like the OECD and the IMF, had since the mid-1990's consistently in their Sweden reports urged the government to do such reforms. Although the recommendations did not have any large impact on the public debate, they influenced both journalists and policy makers.

In contrast, the international influences on the wage-bargaining reforms in the late 1990's were rather minor. The reforms rather had the character of re-establishing the old Swedish traditions of co-operation between unions and employers (the heyday of which was the 1960's and the 1970's) under new institutional conditions where the earlier peak organisations in the labour market had lost their leading roles. An important driving force was a desire on the part of both unions and employers to avoid government intervention in the wage bargaining process. The principle that collective bargaining should be conducted without any involvement from the government has been an established norm in the Swedish labour market since the 1930's. There was, however, a great fear in the labour market organisations that, because of dissatisfaction with the outcomes of wage bargaining, the government would abandon this principle. This was also done temporarily during the crisis in the early 1990's when a government commission formulated guidelines for wage policy and exerted strong pressure on the bargaining parties to follow them.

The reform of the fiscal framework towards the end of the 1990's represents both returns to old thinking and adjustment to new EU principles. It was a return to old principles of budget discipline in the sense that fiscal policy consistently aimed at, and succeeded in achieving,

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[32] See Whalley (1990) and Agell, Englund and Södersten (1995).
[33] Government Commission on the EMU (1997).

surpluses in the 1960's and early 1970's. But the fiscal rules established in the EU Maastricht Treaty and the stability pact were also influential. It was a clearly stated government aim that Sweden should be able to decide whether or not to join the monetary union from a "position of strength".[34] It has also been a key consideration for fiscal targets that fiscal outcomes in normal times should be such that the risk of breaching the EU's three-per-cent-of-GDP deficit ceiling in downturns should be very minor.[35] It is somewhat noteworthy that Sweden, outside the monetary union, appears to have taken the deficit ceiling more seriously than several of the eurozone countries.

4.4 Political consensus or partisan reforms?

On the one hand, political consensus on reforms increases the chance that they will be long-lasting. On the other hand, a requirement for political consensus makes it more difficult to reach decisions on far-reaching reforms. In the Swedish case, most of the reforms have had broad political backing, often based on explicit cross-party agreements. The tax reform, the pension reform, the granting of independence to the central bank and the establishment of a stricter fiscal framework are all examples of this.

The 1990/91 tax reform was based on agreements between the Social Democrats (then in government) and the Liberal-Conservative opposition parties. In line with traditional Swedish decision-making tradition, the agreements were concluded within several government commissions with representatives from the various political parties. The work spanned several years and there was an extensive analytical input from experts.[36]

The pension reform was decided in 1994 under a Liberal-Conservative government. But it was also the result of a cross-party agreement between the Liberal-Conservative parties and the Social Democrats. Moreover, this agreement was concluded in a parliamentary government commission which worked for several years. The work of this commission had been preceded by the work of an earlier government commission in the 1980’s.[37]

Although independence of the central bank was originally opposed by the Social Democrats when it was proposed by a government commission in 1993[38], the reform was decided under a Social Democratic government in 1997. The decision followed a cross-party agreement

[34] Spring Fiscal Policy Bill 2006.
[35] See, for example, Stabilisation Policy in the Monetary Union (2002) and *Finansdepartementet* (2010).
[36] See Agell, Englund and Södersten (1995) or SOU 1995:104 for descriptions of this work.
[37] Palmer (2002) gives an account of the reform process.
[38] *Riksbanksutredningen* (1993).

between the Social Democrats and the Liberal-Conservative parties. The change in the position of the Social Democrats is likely to have been the combined result of the need to adjust to EU rules (after the accession in 1995) and a desire to strengthen the credibility of monetary policy in a situation when Sweden had decided to stay out of the monetary union (see also Section 4.3). There was no new government commission preparing this decision, but the work of the earlier commission was instead used. Initially, in particular blue-collar trade unions were opposed to central bank independence and the commitment to inflation targeting, but they have gradually become more positive: trade union leaders do gradually seem to have realised the value of a clear benchmark for inflation, as this makes it easier to coordinate wage demands within the trade union movement and convince the rank-and-file about the need for reasonable wage demands.

The introduction of the new fiscal framework by the Social Democratic government in the late 1990's was not the result of any explicit cross-party agreements, but it was supported by parts of the Liberal-Conservative opposition. The only change in the fiscal framework that has been controversial was the establishment in 2007 by the Liberal-Conservative government of an independent fiscal watchdog with the task of evaluating government economic policy, the *Fiscal Policy Council*. All opposition parties (the Social Democrats, the Left and the Greens) voted against the establishment of the council with the motivation that it was improper that independent experts would evaluate the policies decided by the "elected representatives of the Swedish people". However, in 2011, these three opposition parties dropped their resistance to the council and entered into an agreement with the Liberal-Conservative parties giving the council a politically broader backing.[39]

Although there have been no explicit grand cross-party agreements on product and service market deregulations, these reforms have not been politically controversial. They were initiated during Social Democratic governments in the late 1980's and then gained momentum during the Liberal-Conservative government in office 1991-1994.[40] The latter government's reforms were accepted by the Social Democrats when they returned to power in 1994 and even continued, although at a slower pace. Large-scale privatisations have been made by both Social Democratic and Liberal-Conservative governments. Many of the deregulation reforms – changes in zoning rules allowing more competition in retailing and the outsourcing of welfare activities to private providers – have been decided by local governments in broad

[39] See Calmfors (2010b) and Calmfors and Wren-Lewis (2011).
[40] See SNS (2007).

agreement between the political parties. Controversies have only concerned isolated areas like the extent to which hospital care could be provided by private business and the conditions under which private schools are allowed to compete with municipal schools.

Since Sweden's EU accession in 1995 was emphasised above as an important driving force for several of the reforms undertaken (Section 4.3), it should be pointed out that EU entry was supported by both the Liberal-Conservative parties and the (majority of the) Social Democrats. Although the accession treaty was negotiated by the then Liberal-Conservative government, the negotiations were conducted in close cooperation with the Social Democratic opposition.

The only reforms that deviate from the common pattern of political consensus are the labour market reforms undertaken by the Liberal-Conservative government since 2006. These reforms have been strongly opposed by both opposition parties and trade unions. This is easy to understand. First, the explicit aim of the labour-market reforms to strengthen the incentives for employment by increasing the return to work, that is to increase income differences between employed and non-employed, goes against the core values of the Social Democrats and the Left, which have been to guarantee high social safety nets. Second, the reforms have weakened the trade unions, where especially blue-collar unions have traditionally provided both economic and political support for the Social Democrats.[41]

4.5 How have vested interests been overcome?

To the extent that reforms producing aggregate gains lead to losses for individual groups, the latter will oppose the reforms. There are several possible ways of overcoming such resistance: (1) to compensate the potential losers through targeted income transfers; (2) to exploit political complementarity between different reforms, that is to sequence reforms in such a way that one set of reforms increases the political feasibility of others; (3) binding commitments to reform in order to avoid time inconsistency problems that may lead to a reversal of announced reform plans; (4) using economic research as a political vehicle for reform; and (5) hiding the full consequences of the reforms for the electorate.

[41] The weakening has occurred both directly and indirectly. The direct effects include elimination of government subsidies to trade unions and tax deductibility of union membership fees. The indirect effects include lower government subsidies to the union-affiliated unemployment insurance funds (administering unemployment insurance in Sweden), which have forced them to raise the membership fees. The consequence has been an exodus from the funds, which have traditionally worked as a recruitment ground for trade unions. Together these effects are likely to have contributed to a fall in the rate of unionisation. In addition, lower unemployment benefits as well as the introduction of an earned income tax credit have put downward pressure on before-tax wages, which has been perceived as negative by trade unions (Fiscal Policy Council 2009, 2010 and 2011).

The Swedish reforms offer examples of all these strategies. The "tax reform of the century" in 1990/91 is a clear-cut case of a reform that is so comprehensive that potential losers could be compensated. The reform was deliberately designed such that the income redistributions in favour of high-income earners from the lowering of marginal tax rates would be offset by other measures, primarily the limitation of the interest deductions. This had the desired effect because loans, and thus tax deductions, were larger for high-income than for low-income groups. High-income earners were also hit harder by increased taxation of various fringe benefits. In addition, the tax reform involved increased transfers to low-income earners. The compensating changes clearly helped muster support for the tax reform from the Confederation of Trade Unions, which at the time had almost a veto power on the policies of the Social Democratic government. However, the tax reform also illustrates the dangers of this strategy, as it was later concluded that the reform was underfinanced, which contributed to the fiscal deficits in the 1990's crisis.[42]

The tax reform in 1990/91 is also an example of the political complementarity of reforms. It was preceded by extensive credit market deregulations in 1985, which basically eliminated earlier restrictions on household borrowing. In the subsequent years, there was a very rapid credit expansion feeding a bubble in property prices. The incentives to borrow were very strong because of asymmetries in capital income taxation: large possibilities to deduct interest payments combined with a low taxation of capital gains. This implied very strong incentives to follow up the credit market deregulations with a tax reform.

At the same time, the tax reform shows the difficulties of handling vested interests in the long run. Although the basic elements of the 1990/91 tax reform have survived, there has been a gradual dilution of the reforms, with many interest groups managing to secure tax benefits for themselves. This includes, for example, selective VAT cuts for food, hotels, ski lifts, cultural events and restaurants as well as a virtual abolishment of the real estate tax (the imposition of which formed a vital part of the original reform).

For other reforms, political complementarity does not seem to have been important except possibly for the deregulations of product and service markets. Here, the strong centralisation of trade unions is likely to have acted as a check on local unions, dissuading them from trying to block deregulations in individual areas. Theoretically, it is also possible that, by reducing

[42] Agell, Englund and Södersten (1995) and SOU 1995:104.

rents, the earlier product and service market deregulations may have reduced the incentives for unions to fight the Liberal-Conservative government's labour market reforms in 2006.

Strong commitments to carry through the reforms have been important in many cases. The cross-party agreements on tax, pension and central bank reforms did serve such a purpose. The need to adjust to EU rules has also been used as a commitment device: for the stricter competition legislation, for central bank independence and (strangely enough in retrospect of recent eurozone experiences) for fiscal consolidation and a stricter fiscal framework. In the 2006 election campaign, the Liberal-Conservative parties committed very strongly to the programme of labour market reforms that they subsequently implemented.[43]

The way economic research has been used as a vehicle for facilitating reforms is particularly interesting. There is a long tradition in Sweden of basing policy changes on thorough analyses carried out by government commissions. As discussed in Section 4.4, such commissions, building on heavy research inputs, prepared the tax, pension, central bank and fiscal reforms. The Liberal-Conservative government that took office in 2006 has also gone out of its way to try to argue (in most cases correctly) that there is a firm basis in economic research for the employment-increasing effects of its labour market reforms.[44]

However, some reforms *may* also have been facilitated by voters' lack of perception of their implications. This has been argued to be the case with the pension reform by the earlier Social Democratic Prime Minister Göran Persson.[45]However, such a strategy does, in principle, appear to be a very dangerous one, as it is likely to foster demands for a reversal of the reforms. However, this has not happened with the Swedish pension reform, perhaps because the economic rationale for it was so strong: the earlier pension system was clearly not sustainable.

4.6 Shock therapy or gradual implementation?

A final issue is whether reforms were carried out as "shock therapy" at one stroke or if the implementation was gradual. The political advantage of shock therapy is that the political costs of reform are taken in a one-off fashion. With gradual implementation, the political

[43] *Alliansens valmanifest* (2006).
[44] These claims have been thoroughly discussed in Finanspolitiska rådet (2008) and Fiscal Policy Council (2009, 2010 and 2011).
[45] He has been quoted saying "I am certain that what we did will not be popular in 20 years' time when those who retire see what we did" (*Dagens Industri* 2005).

costs are instead spread over time. Also regarding this aspect, the reforms in Sweden have been diverse.

As described in Section 3.2, deregulations of product and service markets were carried through in a very slow process. However, this is not likely to have been a deliberate strategy: it rather seems to be the case that the various deregulations followed their own logic and were made on the basis of deliberations specific to the respective area. Once in place, the benefits to consumers of most of the reforms have been so obvious that rolling them back has not been considered a policy option (even by vested interest groups). With pension reform there was, however, a deliberate strategy of gradually phasing in the new rules. But such a strategy is, of course, strongly warranted in this case, as individuals make very long-term planning decisions on the basis of pension rules.

In other cases, shock therapy has indeed been a vital part of the reform process. The most clear-cut case is the 1990/91 tax reform, where the whole idea was to implement a comprehensive package where different parts would balance each other (see Section 4.5). Since the balance was carefully constructed and based on a fragile political compromise under continuous threat from strong interest groups, a swift implementation was highly desirable.

The most controversial parts of the labour market reforms (the reduced generosity of unemployment and sickness insurance) of the Liberal-Conservative government that took office in 2006 were also implemented as shock therapy in 2007/08. The government wanted to take the political costs upfront immediately after the election victory instead of getting into continuous conflict with the trade union movement. The government also hoped that the positive employment effects of the labour market reforms would be clearly visible by the time of the next election in 2010, a hope which was, however, not fulfilled because of the international downturn. It is true that the reforms were extended in 2008-2010, but these extensions mainly concerned the parts of the reforms that were the easiest to sell politically: the earned income tax credits raising employees' disposable incomes.

5. Lessons from the Swedish reform experiences

Sweden suffered a deep economic crisis in the early 1990's with bank failures, output falls, large employment reductions and a rapid accumulation of government debt. This crisis came on top of two decades of stagnating growth. In contrast, the period after 1995 has been characterised by strong macroeconomic performance: high output growth, rising employment and solid public finances. Sweden has fared much better than almost all other EU countries during the current international economic crisis.

A number of economic reforms during the last two decades have contributed to Sweden's transition from macroeconomic failure to macroeconomic success. These reforms include:

- Comprehensive tax reform in 1990/91.
- A gradual process of product and service market deregulations starting in the late 1980's.
- Fundamental changes in the monetary policy regime including moves to a floating exchange rate and inflation targeting in 1992 and to greater central bank independence in 1999.
- Reform of the wage-bargaining process implemented by the parties in the labour market in 1997, establishing a system of informal coordination based on pattern bargaining with the engineering sector as the wage leader, but at the same time permitting individual wage flexibility.
- The establishment of a stricter fiscal framework towards the end of the 1990's, also including a fundamental pension reform.
- Comprehensive general labour market reforms involving various systems administered by the government starting in 2007.

Which are the main political-economy characteristics of the Swedish reforms and which lessons can be drawn for other countries? The following conclusions seem to follow:

1. There is only limited support for the hypothesis that fundamental reforms require a deep economic crisis. Instead, most of the reforms in Sweden have been responses to long-standing problems rather than to acute crises. This applies to the tax reform, the product and service market deregulations, the central bank reform and the general labour market reforms. Only the move to a floating exchange rate and inflation targeting and the establishment of the stricter fiscal framework can be seen as direct crisis responses (although the latter occurred with a lag). The reform of wage bargaining in 1997 had large wage increases in the most recent wage agreements as a trigger, but was all the same more of a response to long-standing problems. However, the overall picture is somewhat confused by the fact that the Swedish decision in 1990 to apply for EU membership, which has played an important

indirect role of stimulating reforms in various areas, was announced in a crisis programme to deal with an acute exchange-rate crisis.

2. In most cases, there has been a strong perception among economists, policy makers and the general public of the problems that the reforms have sought to address. This applies in particular to the tax reform, the establishment of a stricter fiscal framework, the reform of wage bargaining and the general labour market reforms involving the government. The general perception of the problems has both facilitated the reform processes and helped guarantee the sustainability of the reforms.
3. International developments have been important inspirations for many of the reforms. This holds true above all for the product and service market deregulations. Unlike the other reforms, they were not preceded by much public discussion. Instead, the main driving forces were the international trend to such deregulations, especially in Anglo-Saxon countries, and the need to adapt to EU competition rules. Once in place, the benefits of most of these reforms to consumers were so obvious that roll-backs were not considered to be an option. International influences also played a role for the tax, the central bank, the labour market and the fiscal reforms. In contrast, the reform of the wage-bargaining process reflected a desire to return to old Swedish traditions of free bargaining without government interventions.
4. Most of the reforms have been based on a broad political consensus. This is true for the tax reform, product and service market deregulations, the pension reform, the central bank reform and the establishment of a stricter fiscal framework. In several cases, the consensus has been codified in explicit cross-party agreements, often concluded in multi-year government commissions working with a strong expert input. The advantage of this form of decision-making is that the reforms become stable. The disadvantage is that it has often taken a long time to make decisions about the reforms. In the politically very controversial area of labour market reforms involving various government-administered systems, consensus building has not been possible. Here, reforms were instead unilaterally decided by the Liberal-Conservative government.
5. The Swedish experiences illustrate a number of ways of overcoming resistance to reforms from vested interest. They include compensating transfers to potential losers (in the case of tax reform), strong ex-ante commitment (sometimes with the help of cross-party agreements or EU rules as discussed above, sometimes – as with the

general labour market reforms – with the help of widely publicised pre-election promises), and complexity of the reforms making it difficult for the general public to see through them (as was probably the case with the pension reform). A specific feature of decision-making about reforms in Sweden is the frequent use of heavy input from economic research as a basis for change. Such input seems to have been important not only for raising the quality of the reforms but also for increasing their legitimacy.

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Table 1 Average annual GDP growth in Sweden and the euro area, per cent

Actual GDP	1970-1994	EU-12	2.8
		Sweden	1.9
	1995-2011	EU-12	1.7
		Sweden	2.7
Actual GDP per hour worked	1970-1994	EU-10	2.1
		Sweden	1.4
	1995-2011	EU-10	1.3
		Sweden	2.0
Potential GDP	1970-1994	EU-11	2.9
		Sweden	2.2
	1995-2011	EU-11	1.8
		Sweden	2.5

Note: EU-10 is Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain. EU-11 is Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. EU-12 adds Greece to EU-11.
Source: AMECO.

Table 2a Replacement rates after tax at one calendar year of unemployment in Sweden in 2010

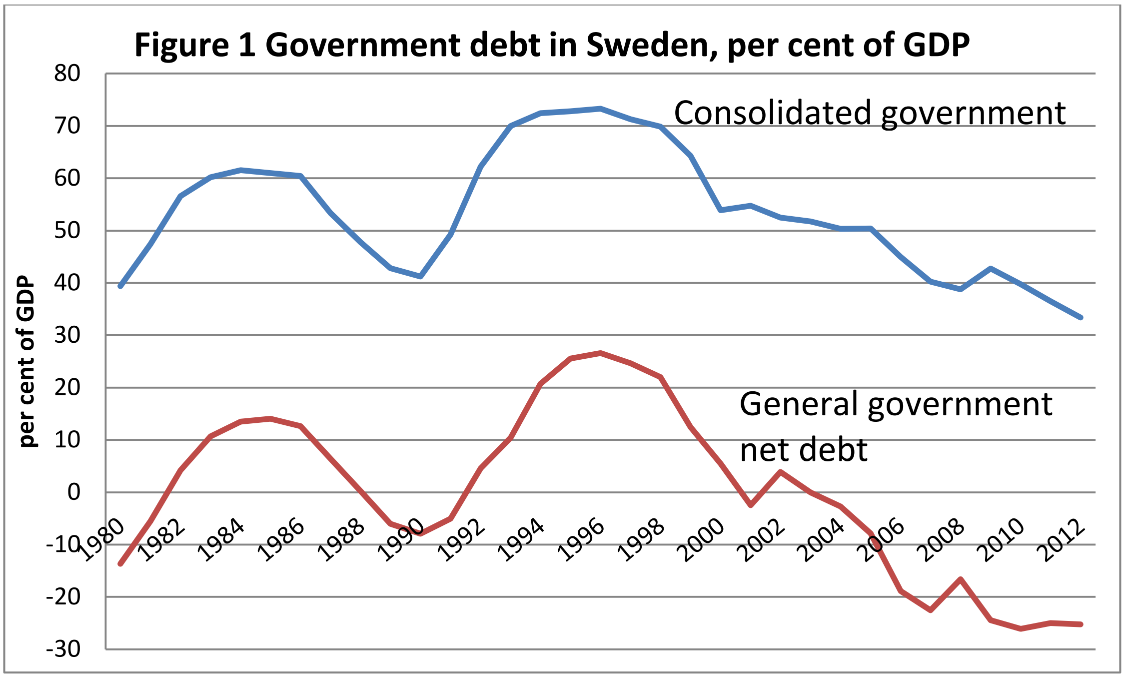
Monthly pay (SEK)	15 000	20 000	25 000	35 000	50 000
Replacement rate 2006	**82.3**	**81.8**	**71.3**	**51.8**	**39.9**
Replacement rate 2010	**73.1**	**68.7**	**56.5**	**42.6**	**33.4**
Change	**-9.2**	**-13.1**	**-14.8**	**-9.2**	**-6.5**

Note: The table shows an individual's total income for one year of unemployment as a percentage of income for one year of work. All estimates assume that the person is between 25 and 64, is a member of an unemployment insurance fund and meets the terms for accrued work and has no income other than earned income or benefits from an unemployment insurance fund (supplementary insurance schemes are thus not included). The monthly pay reported refers to 2010. For 2006, the monthly pay in each income group is assumed to have been 12 per cent lower. The median employee's monthly pay in 2010 is 25 300 SEK.
Source: Fiscal Policy Council (2010).

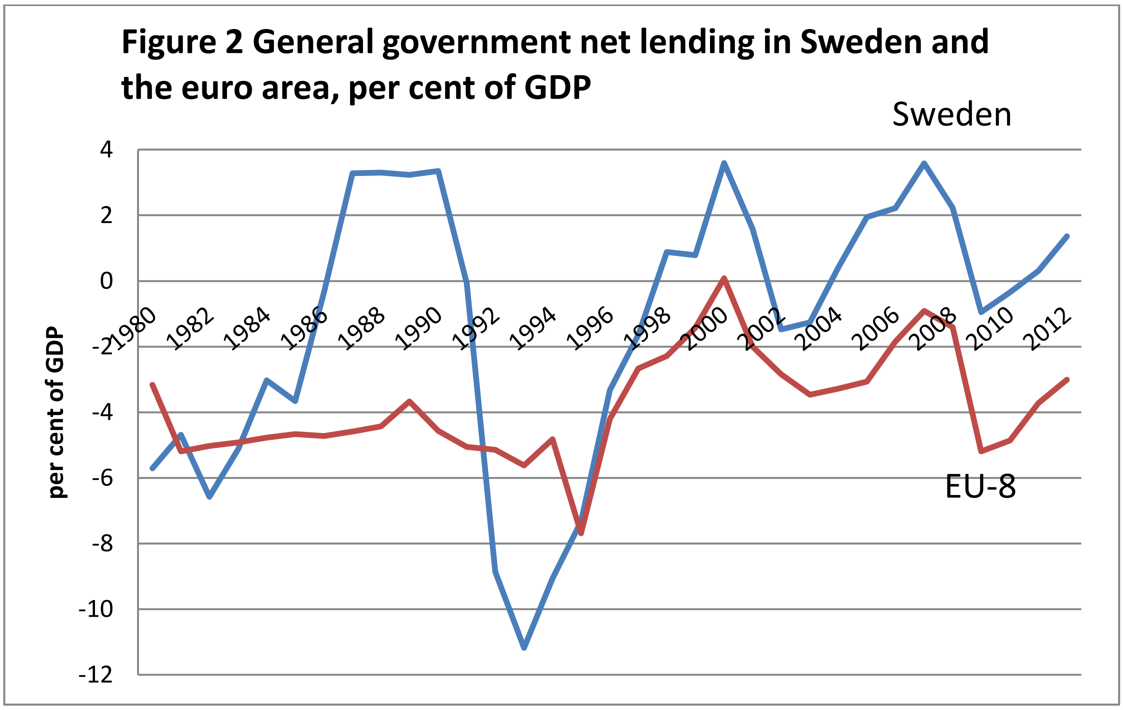
Table 2b Replacement rates after tax for the long-term unemployed in Sweden in 2010

Monthly pay (SEK)	15 000	20 000	25 000	35 000	50 000
Replacement rate 2006	**82.3**	**81.8**	**69.5**	**50.5**	**38.9**
Replacement rate 2010	**62.5**	**62.0**	**56.5**	**42.6**	**33.4**
Change	**-19.8**	**-19.8**	**-13.0**	**-7.9**	**-5.5**

Note: The table shows the income for one year with activity support for people who have been unemployed at least 420 days in per cent of the income from one year's work. See also Table 2a.
Source: Fiscal Policy Council (2010).

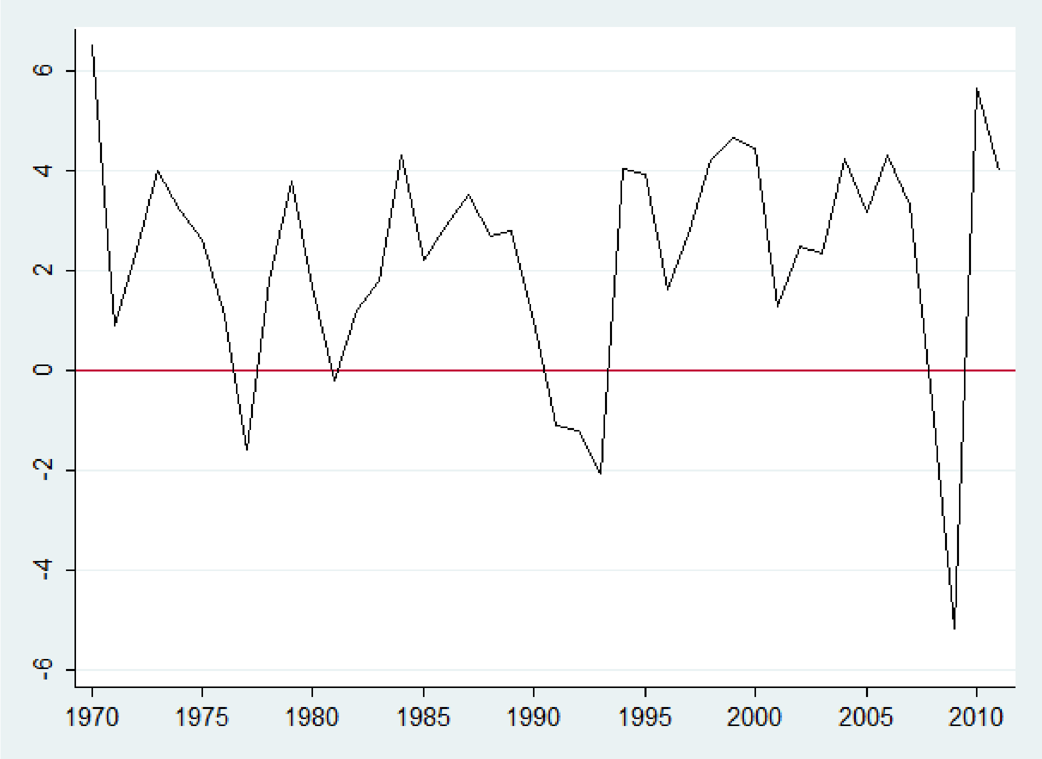


Note: Consolidated government gross debt (Maastricht debt) is defined as general government total debt after internal claims and liabilities in the sector have been netted out. General government net debt is the sector's gross financial debt minus the sum of its financial assets, including both claims by one part of the government sector on other parts of that sector and claims on the private sector. The large difference between consolidated government gross debt and general government net debt mainly depends on large claims on the private sector held by the public pension system.
Sources: Ameco (consolidated government gross debt) and OECD Economic Outlook No. 89 (general government net debt).



Note: EU-8 is a weighted average for Austria, Belgium, Finland, France, (West) Germany, Italy, the Netherlands and Portugal.
Sources: OECD Economic Outlook No. 89 (Sweden), Ameco and own calculations (EU-8).

Figure 3 Annual GDP growth in Sweden, per cent

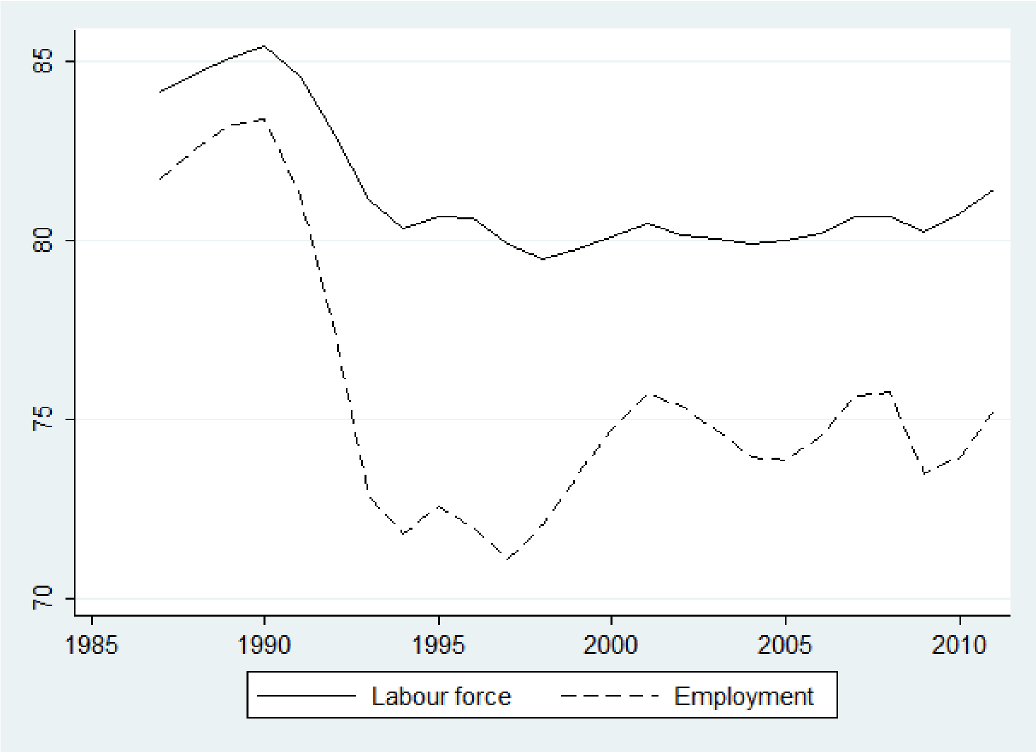


Note: Constant 2005 market prices.
Source: AMECO.

Figure 4 Unemployment in Sweden, per cent of the labour force

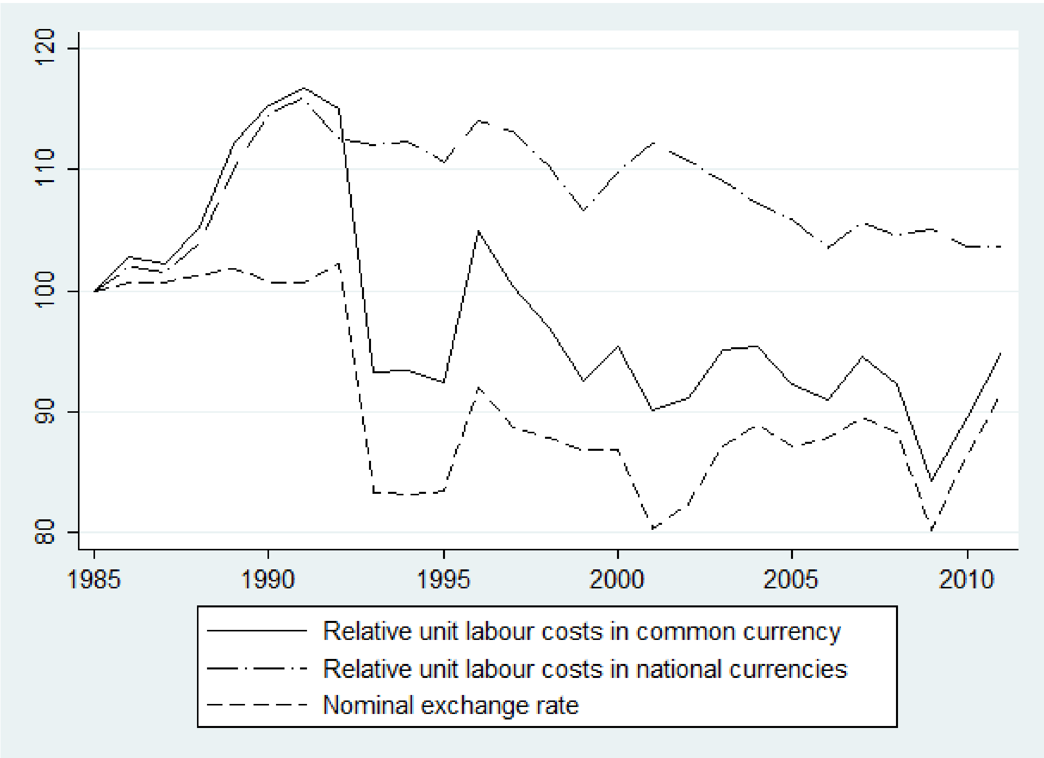
Note: Seasonally adjusted data.
Source: Statistics Sweden.

Figure 5 Employment and labour force participation in Sweden, per cent of working-age population



Note: Seasonally adjusted data, 16-64 years.
Source: Statistics Sweden.

Figure 6 Nominal exchange rate and relative unit labour costs for Sweden, 1985 = 100



Note: The series are computed relative to 23 industrialised countries.
Source: AMECO.

Figure 7

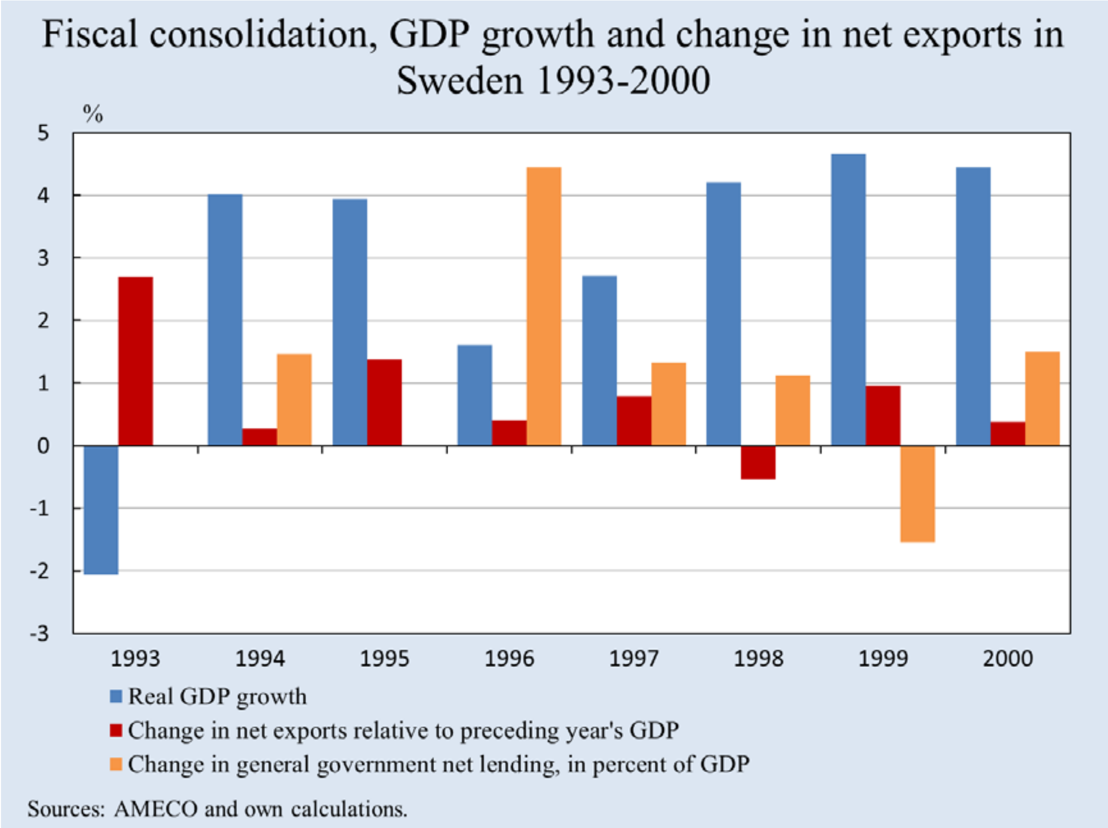
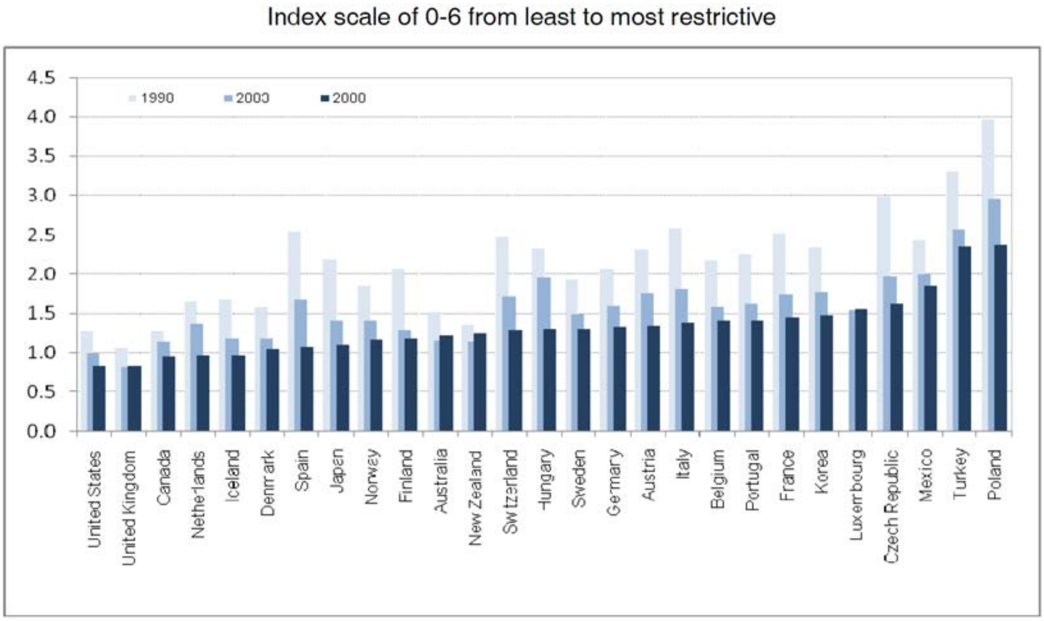


Figure 8 Development of aggregate product regulation since 1998

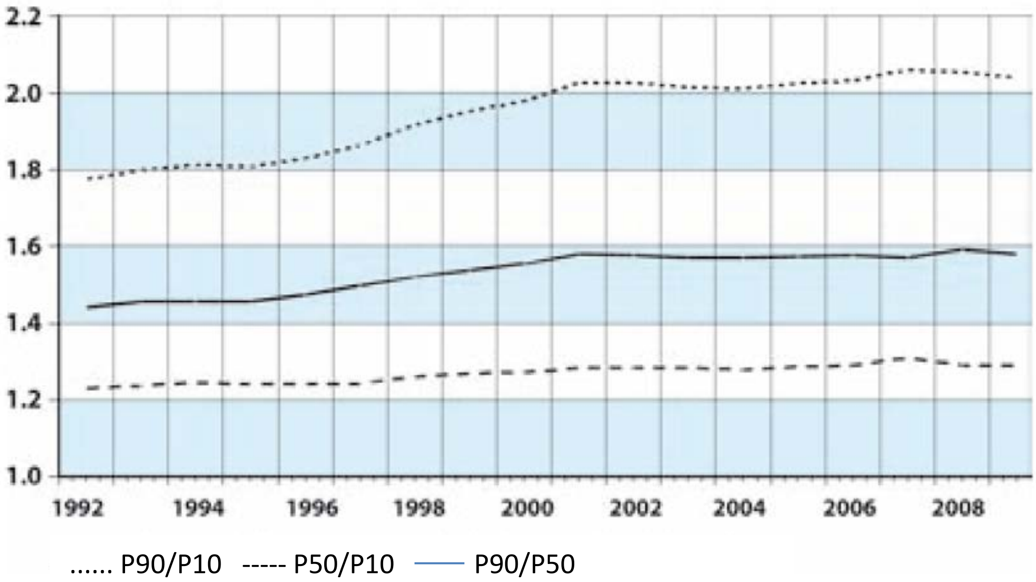


Source: Wölfl, Wanner, Kozluk and Nicoletti (2010).

Figure 9 Nominal wage growth and unemployment rate in Sweden, per cent

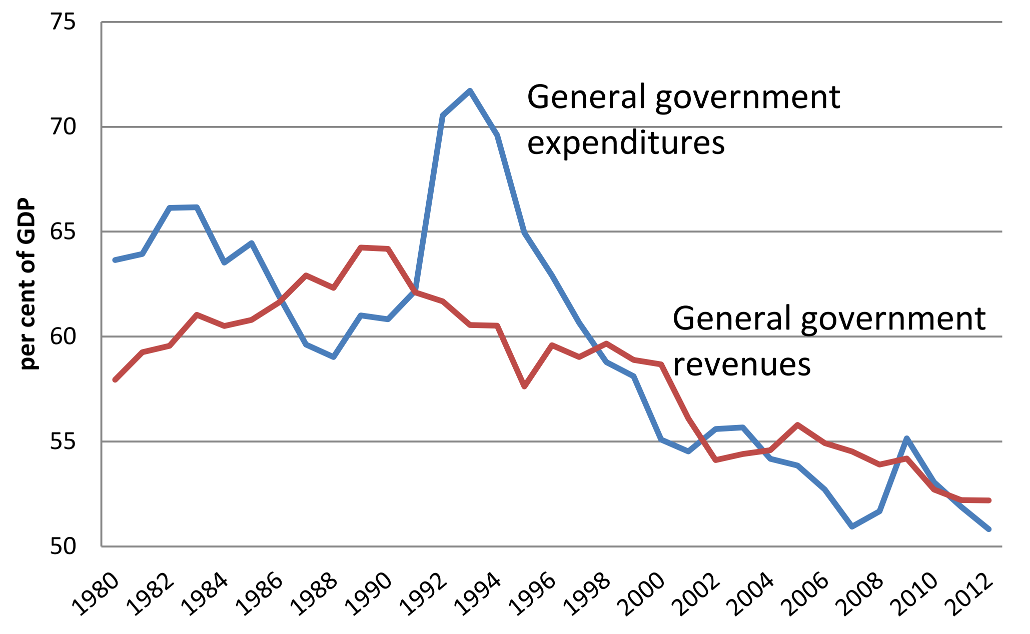
Note: Growth in average nominal gross wages per capita and seasonally adjusted unemployment.
Sources: AMECO and Statistics Sweden.

Figure 10 Wage dispersion in Sweden



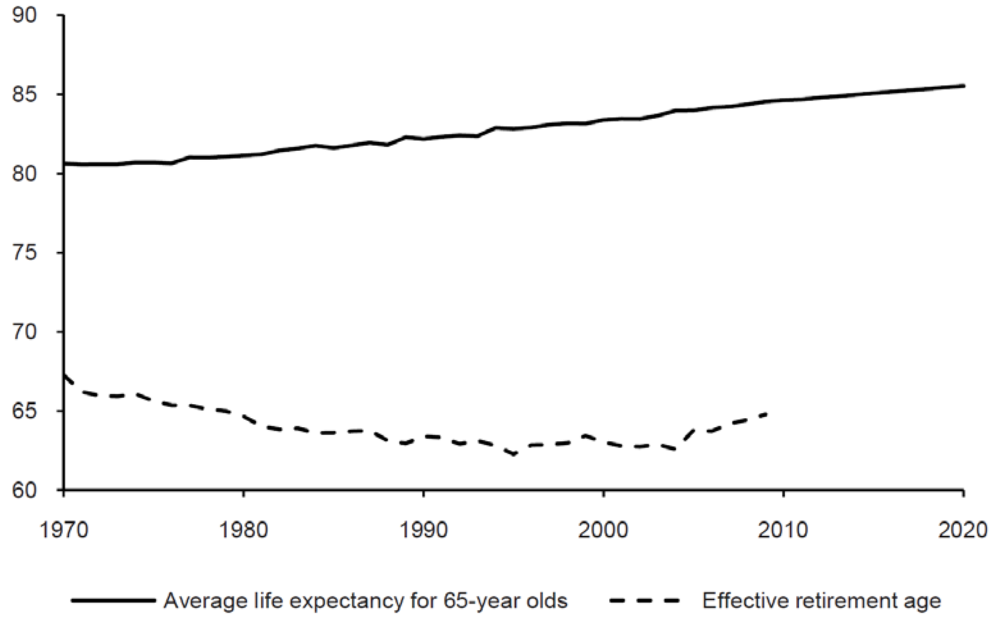
Note: P90/P10 is the ratio between the average wages of the 90th and 10th percentiles in the wage distribution etc.
Source: Medlingsinstitutet (2011).

Figure 11 General government revenues and expenditures in Sweden, per cent of GDP



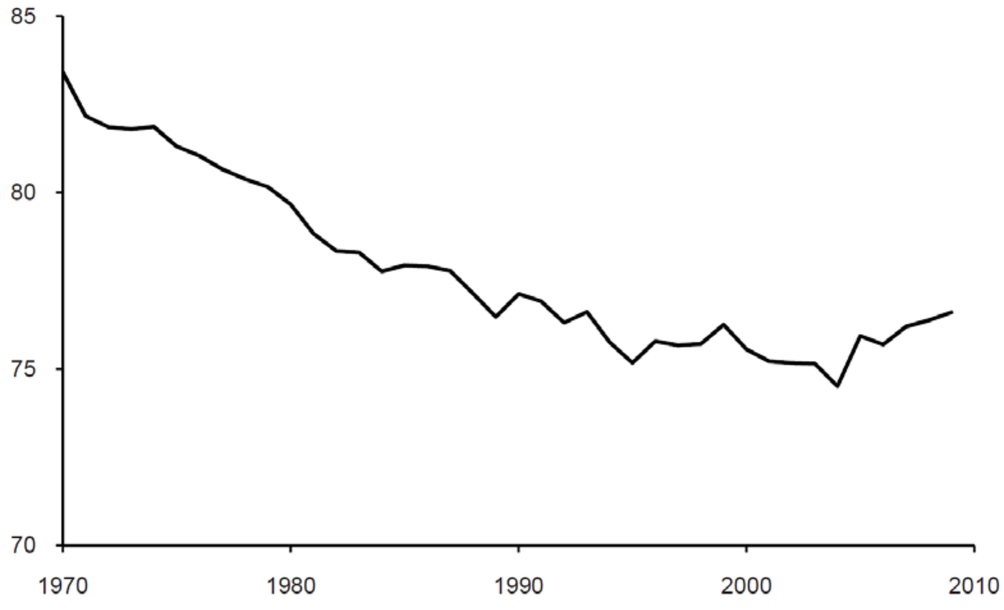
Source: OECD Economic Outlook No.89.

Figure 12a Life expectancy and effective retirement age in Sweden, years



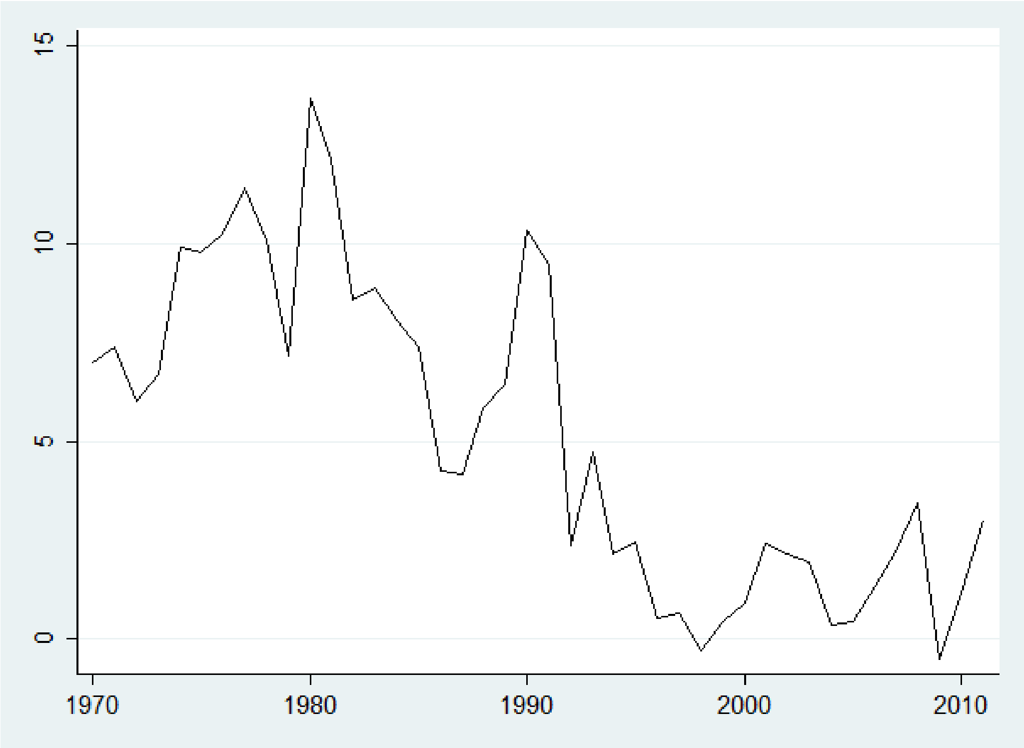
Note: The effective retirement age is defined as the average age of those who are over 40 and leave the labour force to retire.
Sources: SCB and OECD.

Figure 12b The ratio between the effective retirement age and life expectancy in Sweden, per cent



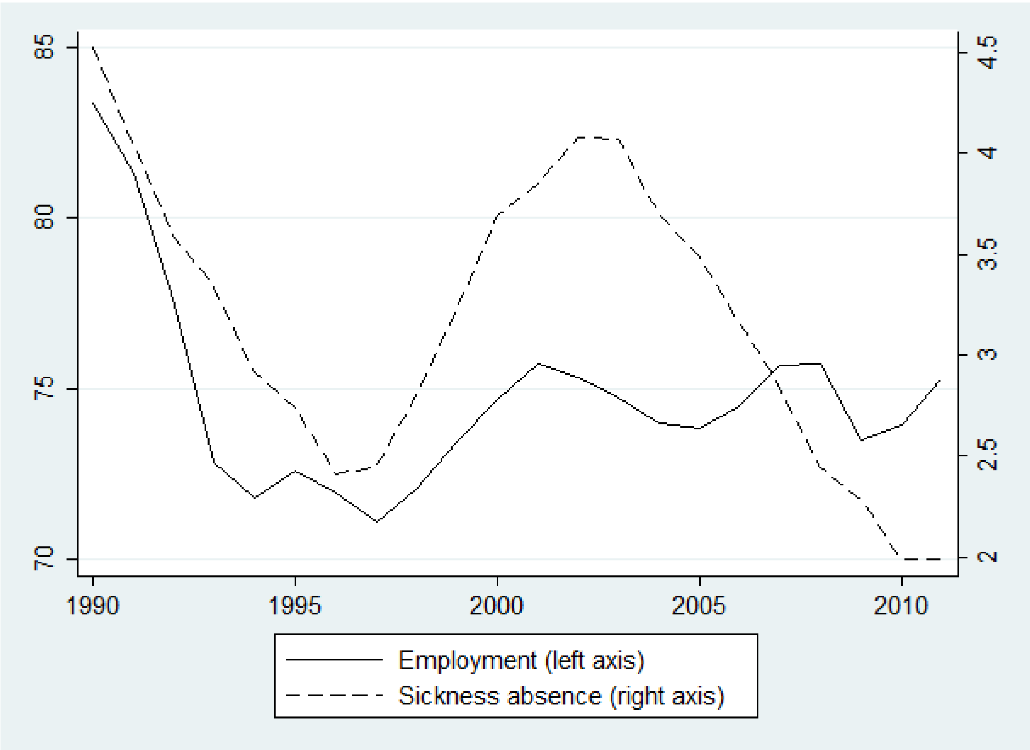
Note: See Figure 12a.
Sources: SCB and OECD.

Figure 13 Inflation in Sweden, per cent



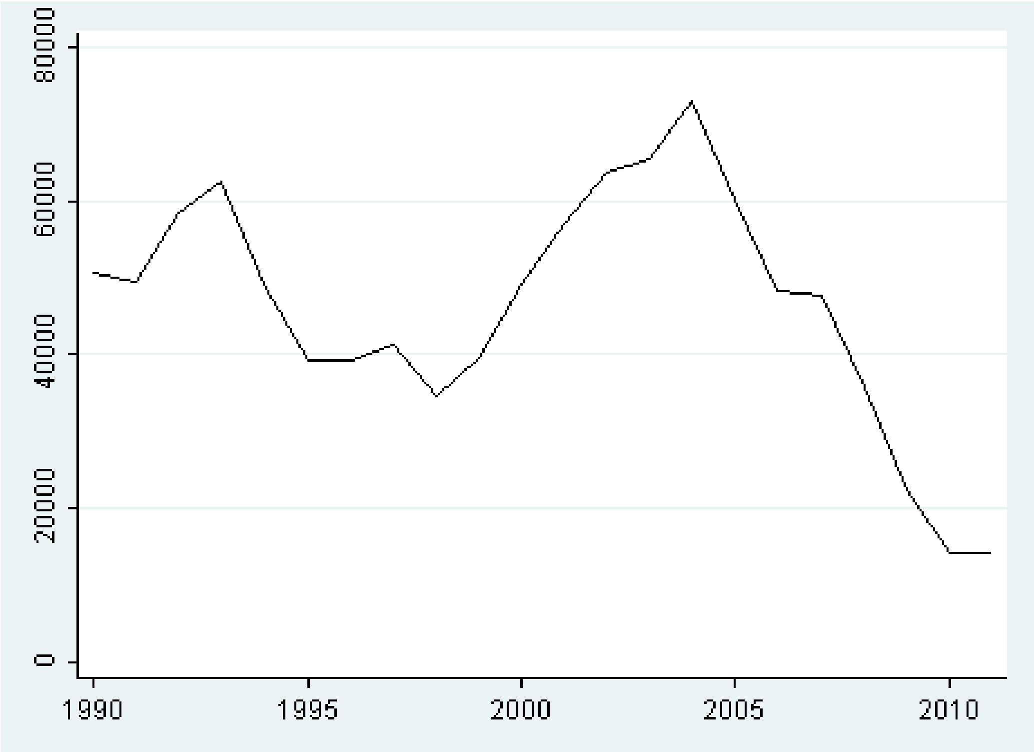
Note: Yearly averages of monthly CPI change compared to the previous year.
Source: OECD.

Figure 14 Sickness absence and employment, per cent



Note: Sickness absence is measured as the number of individuals absent the entire week according to the Labour Force Surveys in per cent of the number of employed. Employment refers to the number of employed in per cent of the population 16-64 years. Both series are yearly averages and the definitions of both series were changed to the ILO standard in April 2005.
Source: Statistics Sweden.

Figure 15 Newly awarded early retirements, thousands



Note: The 2011 figure uses is preliminary.
Source: Social Insurance Agency.