

Economic Survey of Sweden, 2005

Summary

The Swedish economy has undergone impressive changes and has delivered a remarkable surge in productivity since the mid-1990s. Consequently, per capita incomes are slowly making up the ground lost in earlier decades. Labour market performance, however, has been less inspiring. Employment rates have yet to recover to their 1990 peaks and hours of work need to increase to support the welfare state.

The key challenge is to maintain the core of the social welfare system despite an ageing population. While Sweden's fiscal situation is better than most other OECD countries, it needs to be strengthened further to be sustainable in the long term. Because the long-term budget constraint is binding, the tradeoff between public services now and in the future needs to be recognised – the more that is consumed today, the less room there will be for social services in the future. Achieving sustainability requires:

Strengthening the fiscal position. Sweden has ambitious targets for public finances but the commitment to those goals needs to be re-invigorated, otherwise the budget surplus will remain well below the government's target of 2% of GDP. More emphasis should be given to the surplus target as a guide for policy, the margins under the expenditure ceilings should not be used for discretionary spending, and the level of the ceilings should be consistent with the surplus target. Raising taxes might be counter-productive in the long term as high tax wedges hold down labour supply. However, adjusting the tax base by returning to a uniform VAT and cutting marginal income tax rates could help improve work incentives.

This Policy Brief presents the assessment and recommendations of the 2005 OECD Economic Survey of Sweden. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee. The Committee discussed the draft on 19 May 2005.

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Reducing sickness absences. Sickness and disability absences are much higher than in most OECD countries, mainly because sickness benefits are generous and easy to get. Sweden needs to move to the sort of “mutual obligations” approach that it already uses for unemployment insurance. Key reforms would be to check eligibility more carefully; make greater use of independent medical assessments; ensure that the majority of beneficiaries take part in rehabilitation; and introduce some form of experience rating for firms. If Sweden can move towards international best practice in these areas, the sickness problem may be largely solved without having to cut benefit levels.

Raising hours worked. Various leave schemes also contribute to Sweden’s low average working hours, and the government should assess whether the labour supply costs are outweighing the social benefits. *Parental leave* could be adjusted to improve the earnings prospects of women (e.g. by increasing the share that is not transferable between parents). *Study leave* needs to become more job-focussed. *Sabbatical leave* does not help labour supply and should be abolished.

Boosting employment. *Young people* need to enter the workforce earlier. This means redesigning the entry rules to tertiary education (so that more people go directly from school) and encouraging students to finish their studies quicker (by shortening the time for which grants are available, for example). For *older workers*, the government could consider giving greater incentives to delay retirement. *Unemployed people* would get back to work faster if the unemployment insurance (UI) and Activity Guarantee programmes were overhauled. Finally, softening the last-in-first-out rule could reduce sickness absences and enable workers to switch jobs more easily.

Getting better value for money from public spending. There is scope to do more with less in the public sector. Local governments especially need to be more willing to open up to competition and to make more use of outsourcing and benchmarking. The regulatory framework also needs strengthening to ensure that public and private suppliers are treated equally.

The report also includes an in-depth chapter that looks at how to get better quality and value for money from the healthcare system. ■

What are the key challenges?

Sweden’s economic performance over the past decade or so has been impressive in many respects. The business sector has shown its resilience by

brushing off some fairly large shocks, including a global slowdown and the bursting of the telecoms bubble. The current account has swung from a deficit to a large and growing surplus. The fiscal accounts have also moved into surplus, and the government has moved into a net asset position. Inflation has been maintained at a low level. And one of the more encouraging signs for the country’s medium-term outlook is the remarkable surge in productivity. This productivity pick-up appears to be sustainable and can in part be attributed to the various structural and macro-economic policy reforms put in place since the economic crisis of the early 1990s. The labour market performance has been less exemplary, however, even though it is better than in many other European economies. While labour force participation and employment rates are high, especially among women and the elderly, the overall employment rate has not yet recovered to its pre-crisis level and hours of work are low by OECD standards.

Since the underlying economy is sound, the key challenge for Sweden is for the long term: to maintain the core of its welfare system in the face of a variety of internal and external pressures. Public finances are already feeling the effects of several forces, and others are in the pipeline. On the expenditure side, the greying of the population will lift demand for public services such as healthcare and elderly care. As well as these purely demographic spending pressures, there will no doubt be demands to raise public service standards over time, especially in healthcare, both because people will be getting wealthier and because new technologies will expand the range of services that can be offered. On the revenue side, tighter integration within the EU and globalisation more broadly are making it harder to maintain the high tax rates on mobile bases that are needed to finance the country’s ambitious public expenditure programmes. The tax base is also coming under pressure from within as high tax wedges are putting downward pressure on labour supply and encouraging people to operate in the “informal economy” instead. ■

Is the welfare system sustainable?

Maintaining the welfare system – and the egalitarian Swedish model more broadly – is certainly possible, but it will require further policy reforms. Although the fiscal situation is much better than in most OECD countries, it is a little shy of the level needed to ensure that the welfare system will be financially sustainable in the long term. The most immediate priority is therefore to comply with the government’s surplus target of

2% of GDP. Public finances need to be strengthened by at least one percentage point of GDP. Maintaining the surplus at the target level for 15 years or so afterwards would allow net assets to be accumulated that can later be drawn down to finance the age-related spending pressures. Spending cuts and tax increases are both difficult, so the most attractive option for achieving the surplus target is to increase labour supply. Key areas are reducing sickness and disability absences and raising participation by youths, the elderly and immigrants. In the absence of progress in these areas, the government would need to be more ambitious still in its savings plans or be forced to cut back on the welfare state in the future.

Achieving the 2% surplus target would go a long way towards what is needed to safeguard current service levels. However, it would leave no room for anything extra. For the reasons discussed below, tax financing alone will probably not be able to cover this extra demand. This suggests that some further adjustment of the Swedish model may be necessary over time. First, Swedes will need to decide what are the core parts of the system that should still be provided free of charge to everyone. Second, other financing sources may have to be used to a certain extent for some of the lower-priority services. Finally, the tradeoff between public spending now and in the future needs to be recognised. There is an understandable demand for generous parental, study and sabbatical leave, for instance, but the less that people work today, the fewer public services the country will be able to afford in the future.

Equality remains a high priority in Swedish policymaking and among the general public. There is little, if any, acceptance of policies that would permanently widen the income distribution. This is a legitimate social choice. Of course, the best option is to look for reforms that would be good for growth and that would leave the long-run income distribution intact, and then try to find compensation mechanisms to offset any short-run impacts on dispersion. But where that is not possible, such strong distributional concerns can be costly. There is sometimes a tradeoff between equity and efficiency which needs to be recognised. Sweden may be foregoing growth-enhancing reforms which, if implemented, might make it significantly easier to achieve other social objectives. ■

How can public finances be improved?

By international and historical standards, the fiscal framework is working relatively well. Fiscal policy is

constrained by a top-down budget process, multi-year expenditure ceilings and a medium-term target for the general government surplus. Combined with the political will to make them work, they have delivered an average budget surplus of 1.6% of GDP in recent years (so long as the exceptional year 2000 is included), despite several years of economic weakness. However, there are signs that the framework is starting to fray around the edges. While the ceilings have helped rein in expenditure, the government has avoided breaching them in the past few years only because some spending has been channelled through tax expenditures instead. Moreover, the 2005 budget was strongly expansionary and inconsistent with the surplus target. Unless some of this is clawed back, the structural surplus is likely to remain well below the government's 2% surplus target.

Although the framework is still functioning adequately, the commitment to sound public finances needs to be re-invigorated. More emphasis will need to be given to the surplus target as a guide for policy. An important reform would be to ensure that the level of the expenditure ceilings is consistent with the surplus target. The framework could also be augmented with a medium-term debt target to reduce the chances of slippage from year to year. The expenditure ceilings should also be made more binding. The main problem is a tendency to spend up to the limit even in good years. Much of this additional spending ends up as transfers to local government, which means that central government is often adding to the pro-cyclical swings in county and municipal budgets that are caused by the balanced-budget rules. To avoid this, it would help to make sure there is an adequate margin for business cycle fluctuations. In addition, tax expenditures should not be used to get around the ceilings. ■

Is there room to raise taxes?

Raising taxes may look like an easy way to strengthen the fiscal situation but it is likely to be costly and perhaps even counter-productive. In the short term, it would reduce the pressure to reprioritise spending or to find productivity improvements instead. Further out, it would reduce labour supply. High tax wedges have a negative impact on hours of work; raising them further is likely to worsen the situation, in which case it may not generate much in the way of receipts anyway. But there is scope to collect revenue in less costly ways. Making the VAT uniform again and continuing the shift towards green taxes would raise

revenue that could then be used to reduce labour income taxes, thereby improving work incentives.

Raising labour supply is a better option than raising taxes. Avoiding any discouragement to work is crucial in order to preserve national income and to shore up public finances. Sweden cannot afford to have one of the world's most generous welfare systems if labour supply is just average. The main avenue for achieving this is to reduce the disincentives that currently hold down average hours of work. Working hours are low partly as a result of sickness and disability absences, but other forms of time off work along with negotiated reductions in working hours also contribute to the problem. There are several pockets where employment could be enhanced as well. ■

How can sickness absences be reduced?

On a normal day, nearly a fifth of the potential workforce is on sick leave or receiving a disability benefit. The sickness rate has soared since 1998, especially among long-term absences, and is close to an all-time high (it has edged back from its peak more recently, but much of the improvement is because people have moved onto disability benefits instead). The causes of the problem are not hard to find. Compared with other OECD countries, sickness insurance is both generous and easy to get. Swedes have a legitimate social goal of protecting sick people from undue hardship. However, the more generous the system, the more vigilant policymakers must be about ensuring that benefits are reserved only for those who need them. In this respect, Sweden falls well short of international best practice. However, an overly hard line is not necessary. Simply moving towards the middle of the pack would help a great deal. By doing so, the sickness problem may be largely solved without having to directly reduce benefit rates.

The government has set a target of halving the number of sick-listed people by 2008. It has taken some steps to try to tighten up administration, especially by bringing local offices under its wing. But tougher enforcement of a soft system is not enough. It needs to develop the sort of "mutual obligations" approach that is already used for the unemployed, which means placing greater responsibilities on the sick person, the employer and the social insurance office:

- *Eligibility criteria need to be tightened further.* Despite attempts since 2003 to tighten up, almost everyone who requests sick leave is granted it. There are several options for dealing with this, most of which are common practice in other countries. In the

initial stages, doctors need to be more thorough in assessing a person's work capacity and should be given greater support by the social insurance office if they feel that a request should be denied. To ensure that short spells do not become long ones, extending a medical certificate should be less easy (for instance, not over the telephone), and benefits should have a maximum duration of one year. Independent medical assessments by a social insurance doctor should be introduced for long-term sickness and disability recipients. It would also help if the ultimate decision to grant long-term benefits were made in a regional or central office and by a panel of experts, rather than, uniquely, by local politicians. Once a benefit is granted, work capacity should be regularly re-assessed (the government is trying to do this, but it is not clear how rigorously the policy is being implemented in local offices). A full-scale review of the existing stock of long-term recipients may also be warranted, and occasional random checks could be re-introduced.

- *Receiving a benefit should entail certain obligations for the sick person.* In most cases, benefit receipt should depend on participation in vocational rehabilitation or other integration measures. In general, the earlier this starts the better. The new policy of having a meeting after a few weeks among the various parties is a good one, but it is important that this is done on time. Moreover, the social insurance office needs greater powers to act when a beneficiary refuses rehabilitation.
- *Increase incentives on employers.* From this year, employers are required to pay the first two weeks of sick pay plus 15% of sickness benefits for the rest of the spell unless the individual is working part time or undergoing rehabilitation. The aim is to get people into rehabilitation earlier, but it is unclear whether this is the best way of going about it. The government should monitor the response of companies to this new regime; if it is not having the intended effect, it could be replaced with a higher up-front cost for employers but with a limited duration (for example, covering sick pay for the first two to three months). Employers' incentives could also be sharpened by introducing industry or firm experience rating. As a first step, different sickness insurance premiums could be set for public and private employers. Introducing a clearer division between workplace injuries and the general sickness insurance scheme would also help, as it would separate out the conditions over which companies have some influence. Steps may also be needed, however, to minimise any adverse selection problem if firms

were to respond by not hiring high-risk groups (although this has not been a major problem in the Netherlands).

- *Extend the waiting period.* A one-day wait is short by European standards, and Sweden's past experience shows that extending it could have a big impact on short-term absences. It may also help change the culture surrounding sick listing.
- *Monitor partial or part-time sick leave.* The government is encouraging partial benefits as a way of keeping people attached to the workforce. However, they can be unhelpful if they invite a higher inflow and are used merely as an income top-up for workers who want to scale back their hours for lifestyle reasons. Sweden will need to rethink its approach if it finds that partial benefits are being used in this way.
- *Reduce the extent to which sickness and disability benefits are used for early retirement.* People retiring early are often better off taking the sickness insurance path so that they get a higher pension when they turn 65. One solution is to change the rules so that benefit income does not count as much as earned income towards the defined-contribution pension.

Taken together, these proposals would imply a radical shift in Sweden's approach to sickness and disability insurance, making it more similar to approaches elsewhere. ■

Have work-leave schemes become too generous?

Several paid leave schemes have been introduced for various social reasons, but they have the side effect of reducing effective labour supply. In total, they contribute as much as sickness to lost work time:

- The *parental leave* scheme has valid family policy objectives but may have become too generous in the sense of harming women's labour market prospects. The social goals of the scheme need to be traded off against these costs. In general, measures that increase the duration of mother's leave further should be avoided so as not to aggravate gender segregation and human capital loss, which are detrimental to longer-term career prospects. But one way to improve the scheme would be to increase the share that is not transferable between parents.
- *Study leave* is aimed at making it easier for older workers to retrain, but many use it instead for personal enjoyment or as a break from work. This problem could be reduced if study grants were limited to only those courses that are clearly job-related.

- A paid *sabbatical leave* scheme was introduced this year whereby employees can take up to a year off and be replaced by an unemployed person. The aim is to provide workers with a chance for recreation or personal development (even though the study leave scheme gives ample scope for the latter) and to give the unemployed a foothold in the labour market. While small, there is likely to be pressure to expand the programme. It should be abolished instead. Workers who want extra holidays can always negotiate them, but they should not be paid for by the taxpayer. Furthermore, arguing that this scheme benefits the unemployed relies on the misperception that there is only a fixed amount of work to be shared around (the "lump-of-labour fallacy"). ■

How else could labour supply be increased?

Younger adults are another under-used source of labour supply. They tend to enter the workforce later than in most countries, partly because of a late start to university. Admission is based mainly on grades, but there are plenty of ways to improve one's chances by studying for an extra year or two in a post-secondary programme. This creates a pointless "arms race", at the end of which mostly the same people gain entry, but it takes an extra couple of years to achieve. Some simple solutions include giving preference to people who qualify directly from school and not granting bonus points for irrelevant work experience. Once students have started studying, generous grants and an absence of tuition fees mean they are in no hurry to graduate. One way to encourage them to finish more rapidly and choose courses more relevant to the labour market would be to introduce modest tuition fees backed by income-contingent loans. But if that is not acceptable, other ways to improve efficiency should be found. For example, Sweden could consider Norway's new policy of converting some of the student's loans into grants if studies are finished within the prescribed period. In addition, income support rules that allow students to take a year of paid holiday during a course should be modified: grants should be given only for the minimum duration of a course, while those who want to take longer could finance that through the loan scheme.

There is also scope to increase participation among older workers, even though Sweden does better than most other OECD countries in this respect. The incentives to retire early that are embedded in the public pension system are lower than in many countries because,

although the pension can be taken at any time from age 61, the payout rate is increased the longer somebody stays working. However, there are two reasons why it may want to consider tilting incentives even further, going beyond neutrality. First, while the current adjustment is appropriate for an actuary, most people probably have a subjective rate of time preference that is higher than the standard discount rate. It therefore takes a bigger financial incentive to encourage them to postpone their retirement. Second, the tax they would pay if they stayed at work has positive spillovers for the rest of society, such as providing more room for better welfare services in the future. Society and public finances will be better off so long as the extra taxes exceed the financial cost of the incentive.

Improvements to the unemployment insurance (UI) system could lower the rate of joblessness, thereby providing additional labour input. The administration of UI is patchy. Similar cases can be treated differently across the country, with some local offices being more likely than others to extend a benefit beyond the normal maximum. In addition, while the *Activity Guarantee* is an improvement on the previous system, it is not being used as well as it should be. It is designed to provide full-time, tailored labour market programmes for the long-term unemployed who need special help. Instead, it is being used to give unlimited access to UI benefits. To deal with these problems, the institutions should be streamlined (by merging the national and local labour market boards, for example), local case offices need to apply the rules consistently, sanctions on those who are not actively looking for work should be strengthened, and the *Activity Guarantee* should be of limited duration and offered only to those who need intensive programmes. In general, Sweden would get better value for money from its active labour market programmes if they were shorter and started earlier in the unemployment spell. This would best be done in conjunction with the introduction of profiling in order to minimise the risks of spending money assisting people who would easily find a job by themselves.

Job prospects for marginalised groups are likely to be raised if employment protection legislation (EPL) were eased. While there is no clear international evidence that EPL affects the unemployment rate, there is evidence that strict EPL reduces employment and participation rates. In Sweden, the main restriction is the seniority or “last in first out” rule. This is designed to give extra protection to older workers and to reduce the amount of stigma associated with being made redundant. However, it may have several adverse side-effects. It risks locking people into less-suitable jobs (and Swedes do stay longer in the same job than

employees in other countries). It reduces the probability that an employee might start a new venture for themselves if they lose their acquired tenure rights by doing so. It may make sick people more reluctant to change jobs, which in some cases might eliminate the cause of their illness in the first place. Finally, it may raise the sickness rate for another reason, as there are some signs that absenteeism is higher when there is strong job protection. ■

How can the public sector be made more efficient?

Another way to strengthen public finances is to raise the efficiency of the public sector. Opening up to competition can be a powerful way of achieving this. Ultimately, all levels of government should think about whether the public sector needs to provide certain services at all. There is still a tendency in Sweden to think that, if the government has to step in, it must also produce the services itself. Public policy objectives can often be achieved through regulation and outsourcing instead. Although exposure to competition and the regulatory background have got better over the years, there is room for further reform. First, the market activities of municipalities and other public institutions should be subject to normal competition legislation, and the competition authorities should have the power to impose sanctions on local governments. Second, the public procurement process needs to be improved so that there is a level playing field between internal and external suppliers. Third, more use of benchmarking could help uncover best practice and show up the poorer-performing local governments. Finally, there is considerable scope for selling state assets, especially in competitive parts of the business sector. ■

What are the challenges for healthcare?

The *Survey* also includes an in-depth look at Sweden’s healthcare system. By international standards, it is in good shape. Healthcare is of a high quality, the system is relatively well funded, and the various players have been innovative in the way they finance and deliver services. However, there are some problems around the edges. The main challenges are to improve access to primary care, lift quality in the lower-performing regions, increase value for money in the hospital sector and put financing on a more stable and sustainable basis.

Too many people go to a hospital for their primary care because there is a shortage of GPs and because doctors work short hours. The number of family doctors might be boosted if it was easier for specialists in other fields to retrain as specialists in family care. Doctors could be encouraged to work more, deal with patients more efficiently and have more convenient consultation hours by introducing mixed payment systems that include a fee-for-service element. In the hospital sector, the Waiting Time Guarantee should be adjusted to make it consistent with the principle that those most in need should be treated first (for example, by making duration in the queue just one of several factors that determines when a person is treated).

Decentralised responsibility for healthcare has its advantages. It has allowed counties to experiment with different ways of running their systems, which is one reason why Sweden's healthcare system is relatively innovative and flexible. However, excessive decentralisation in some areas affects quality and patient safety (for example, too many emergency units are below the minimum safe size, while insufficient co-ordination between counties and municipalities leads to problems in the grey area between hospital care and social care). It also affects efficiency because of duplication. The government should consider reducing the number of counties to perhaps half a dozen or fewer, which would also help the counties re-organise their hospitals so that fewer are below safe size. Co-ordination between municipalities and counties needs to improve, especially for people with psychiatric, drug or alcohol problems.

The hospital sector could be run more efficiently. There are considerable regional differences in efficiency, quality and medical practice. In most counties, there is a need to: enhance the role of purchasers; improve hospital funding mechanisms, including some form of per-case payment; improve manage-

ment through better case costing systems, especially in psychiatry, outpatient and primary care; and make more use of multi-year budgets. The government could also encourage a greater diversity of providers by removing restrictions on for-profit hospitals or allowing exemptions on a case by case basis – but only when an adequate regulatory framework is in place to minimise the risk of cream skimming. ■

How should healthcare be financed?

The current funding arrangements create several problems. With balanced-budget rules, healthcare financing is too cyclical. Possible solutions include stabilisation funds, giving counties a less-cyclical tax base (such as property taxes), calculating the tax base as a moving average and moving to multi-year budgeting. Second, the income tax base may not grow fast enough with an ageing population. Counties may need a share of the national VAT, for example. Finally, the high-cost protection ceilings on user charges should be re-assessed because patient charges are not having the desired effect of channeling people to the right level of service. The government could raise the ceilings, which have fallen significantly in real terms, or make them a fixed percentage of household income instead of a flat amount. ■

For further information

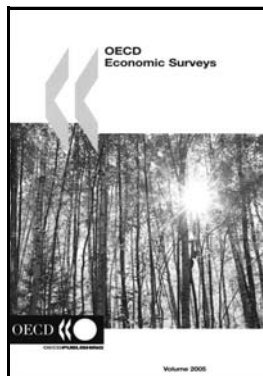
Further information on the Survey can be obtained from:

David Rae, Tel.: (33-1) 45 24 88 23
E-mail: david.rae@oecd.org; or

Martin Jørgensen, Tel.: (33-1) 45 24 17 44
E-mail: martin.jorgensen@oecd.org ■

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- **Economic Outlook No. 77**, June 2005. More information about this publication can be found on the OECD's Web site at www.oecd.org/eco/Economic_Outlook.

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Public Affairs and Communications Directorate.

They are published under the responsibility of the Secretary-General.

Where to contact us?

FRANCE

OECD Headquarters
2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY

OECD BERLIN Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
E-mail:
berlin.contact@oecd.org
Internet:
www.oecd.org/deutschland

JAPAN

OECD TOKYO Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0035
E-mail: center@oecd-tokyo.org
Internet: www.oecdtokyo.org

MEXICO

OECD MEXICO Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560
MEXICO, D.F.
Tel.: (00.52.55) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail:
mexico.contact@oecd.org
Internet:
www.oecdemexico.org.mx

UNITED STATES

OECD WASHINGTON Center
2001 L Street N.W.,
Suite 650
WASHINGTON D.C. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
Internet: www.oecdwash.org
Toll free: (1-800) 456 6323

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